

# THE COMMODITY FUTURES MODERNIZATION ACT OF 2000 AND RECENT MARKET DEVELOPMENTS

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## HEARING BEFORE THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

EXAMINING THE PROPOSED REAUTHORIZATION OF THE COMMODITY  
FUTURES TRADING COMMISSION, FOCUSING ON THE COMMODITY FU-  
TURES MODERNIZATION ACT OF 2000 AND RECENT MARKET DEVEL-  
OPMENTS

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SEPTEMBER 8, 2005

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# **THE COMMODITY FUTURES MODERNIZATION ACT OF 2000 AND RECENT MARKET DEVELOPMENTS**

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**THURSDAY, SEPTEMBER 8, 2005**

U.S. SENATE,  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,  
*Washington, DC.*

The Committee met at 10:05 a.m., in room SD-538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

## **OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY**

Chairman SHELBY. The hearing will come to order. This morning, the Committee will examine the impact of the Commodity Futures Modernization Act of 2000 and recent market developments. Five years ago, Congress passed the Commodity Futures Modernization Act, making significant changes to the Commodity Exchange Act and the regulation of derivatives. The CFMA was the product of a comprehensive hearing process involving the Banking Committee and the Agriculture Committee. The Act provided for legal certainty and regulatory clarity for over-the-counter derivatives, modernized the regulatory regime for futures trading, and established a framework for trading security futures products. The CFMA recognized that certain financial products have attributes of securities and futures and provided for a regulatory regime intended to assure that the purposes of the Commodity Exchange Act and the Federal securities laws are carried out.

As the CFTC's 5-year reauthorization approaches, it is time to revisit and to evaluate some of the provisions contained in the CFMA. Since passage of the CFMA, the futures markets have continued to evolve as innovative products, and new market participants now define the marketplace. Although futures contracts were originally tied to agricultural and other physical commodities, the vast majority of trading now involves financial instruments such as foreign currencies, stock indexes and government securities. Given that certain futures contracts based on financial instruments can function as a proxy for that financial instrument, this Committee has a significant role to play in examining any proposed changes to the regulatory lines established in the CFMA.

During the current reauthorization process, several issues have arisen that are indicative of the changing nature of the futures markets. Specifically, we will examine security futures and consider how portfolio margining could apply to these products and se-

curities options. Given the hybrid nature of certain futures, it is important to appreciate the joint regulatory regime overlaying these products. We will also consider proposed definitional changes to the term “narrow-based security index” that are intended to expand the scope of future products that can be based on debt and foreign securities. These changes are significant because they govern regulatory jurisdiction. We are mindful of the investor protection concerns regarding investor protection, insider trading, and market manipulation underlying the current statutory definition. Finally, we will consider several issues related to the sale of foreign exchange contracts to retail investors. Some have raised concerns regarding the scope of foreign exchange products subject to the CFTC’s authority, and some have also proposed new registration requirements for certain counterparties involved in the sale of retail foreign exchange products.

While considering legislative proposals to amend the Commodity Exchange Act, it is important to ensure that any resulting amendments do not capture financial products specifically excluded from the regulatory regime created by the CFMA. Expanding the CFTC’s jurisdiction to include new products and market participants must be carefully examined to guard against unintended consequences that could undermine the legal certainty, grant competitive advantages or leave investors without necessary protections.

The Committee’s examination of the CFTC’s reauthorization is consistent with the Senate’s approach to these complex issues in the year 2000. As the Senate considers reauthorization of CFTC, I look forward to working with Chairman Chambliss and the other Members of the Committee of the Agriculture Committee. We all share an interest in ensuring a fair, efficient, and competitive marketplace for financial products.

We will have two panels here this morning. First, we will hear from the members of the President’s Working Group on Financial Markets. During consideration of the Modernization Act in 2000, 5 years ago, the Working Group’s recommendations were invaluable and served as a roadmap for reform. I once again expect the Working Group’s recommendations to inform and guide the current reauthorization process. Any legislative proposals to redraw the regulatory lines should receive a complete examination and endorsement by the Working Group.

Representing the Working Group this morning we have Mr. Randal Quarles, Under Secretary for Domestic Finance, U.S. Department of the Treasury; Mr. Robert Colby, Deputy Director of the Division of Market Regulation, the Securities and Exchange Commission; Mr. Patrick McCarty, General Counsel, Commodity Futures Trading Commission; and Mr. Pat Parkinson, Deputy Director of the Division of Research and Statistics, the Federal Reserve.

On the second panel today, we will hear from a range of market participants. The witnesses on the second panel will be Mr. Charles Carey, Chairman of the Chicago Board of Trade; Mr. John Damgard, President, Futures Industry Association; Mr. Terrence Duffy, Chairman, Chicago Mercantile Exchange; Mr. Sandy Frucher, Chairman and Chief Executive Officer of the Philadelphia Stock Exchange, and Mr. Mark Lackritz, President, Securities Industry Association; Mr. Robert Pickel, Executive Director and Chief

Executive Officer, International Swaps and Derivatives Association; and Mr. Daniel Roth, President, National Futures Association.

I thank each of you for appearing here this morning, and we look forward to your testimony and your participation.

Senator Sarbanes.

#### STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I want to commend you for holding this hearing, and for your leadership in asserting the Committee's role with respect to some of the issues that are raised with respect to this matter.

Chairman SHELBY. Thank you.

Senator SARBANES. And I also want to acknowledge the work that Senator Crapo's been doing on this issue. We very much appreciate it.

Five years ago this Committee, working closely with the Agriculture Committee, in a joint deliberative process—it was a very cooperative working effort at that time—produced the Commodities Futures Modernization Act of 2000, the CFMA. Some of us will recall that process included a joint hearing of the two Committees to receive testimony from the agencies which comprise the President's Working Group on Financial Markets. Those agencies are actually represented again today here at the witness table.

An important part of the CFMA was the authorizing of trading of security futures, ending the prohibition that had been established by the Shad-Johnson Accord. The CFMA permits trading of security futures subject to joint regulation by the SEC and the Commodities Futures Trading Commission. The Act requires that the SEC and the CFTC, "jointly prescribe regulations to establish margin requirements," and that "the margin requirements for a security futures product be consistent with the margin requirements for comparable options contracts."

It is obviously appropriate for this Committee to review the impact of the earlier law, especially, in light of legislation that the Agriculture Committee marked up in late July. Fed Chairman Alan Greenspan wrote on July 20 of this year that legislative provisions which were adopted by the Agriculture Committee "include novel terms and approaches," and that the "issues are complex and the potential for legislation to have unintended consequences is considerable." He went on to say, "I believe it would be a mistake to enact legislation that has not been thoroughly evaluated by the PWG"—the President's Working Group—"and by market participants that may be affected." I think this is an observation to which we need to pay close attention.

One provision of the bill, S. 1566, the one marked up in the Agriculture Committee, would implement a pilot program for single stock futures that would remove certain regulatory authority from the SEC. The seven U.S. options exchanges stated in a letter dated July 20 of this year that they oppose this because it is "not consistent with the regulatory and competitive parity between security futures and security options established in the CFMA." That was an issue that we really worked very hard on back when we did that earlier legislation.

There are also other issues and provisions of the S. 1566 which merit our attention and which the witnesses will be addressing.

The Chairman of the Agriculture Committee said in the markup that his Committee was passing the bill to move the legislative process along and to stimulate discussion, which is of course what is happening here today.

[Laughter.]

And he also said that he was committed to working over the next few months with the Senate Banking Committee. I look forward to working closely, as we have on so many issues, with Chairman Shelby and Senator Crapo, who has played an important role in all of this, as we try to resolve this matter.

We have a very collaborative working relationship the last time around, and I hope that we will be able to achieve that this time around as well. I think it is very important in ending up with a constructive resolution of some of these issues.

Mr. Chairman, I join with you in welcoming the panels that are before us. I have another engagement this morning, and I am not quite sure how long I will be able to stay. I do want to say with respect to the first panel that both Bob Colby at the SEC and Pat Parkinson of the Fed have each served a quarter of a century with distinction at their respective agencies, and I want to acknowledge that here this morning. And Pat McCarty has served for more than 15 years with a number of agencies and on House staff before that. And, Mr. Quarles, we welcome you to the panel, and you are a new started, so to speak, but we wish you the very best as you move ahead in your responsibilities.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Senator Allard.

#### **COMMENTS OF SENATOR WAYNE ALLARD**

Senator ALLARD. Mr. Chairman, thank you. I am not going to make any opening comments.

Chairman SHELBY. Senator Crapo.

#### **STATEMENT OF SENATOR MIKE CRAPO**

Senator CRAPO. Thank you very much, Mr. Chairman, and I want to say at the outset I appreciate both you and Senator Sarbanes and the efforts that you have made to put this hearing together to work on this year.

Chairman SHELBY. Thank you for the work you did.

Senator CRAPO. Thank you very much.

Mr. Chairman, I strongly believe that we need to reauthorize the Commodity Futures Trading Commission, and frankly, I think we need to act promptly. But it is more important that we do not undo the excellent work that is already based largely on the President's Working Group back in 1999. Many individuals and groups have referred to the subsequent legislation, the Commodities Futures Modernization Act of 2000, as a landmark in futures regulation. The end result, measured in substantial increase in market volume, has been show to work well and to work very well.

The careful balance that was struck in the CFMA established a tiered system of regulation depending upon the market participant's decision to trade on a registered futures exchange or on a de-

derivatives transaction execution facility, and depending on the sophistication of the parties involved. The CFMA also created legal certainty for swaps, prohibiting the CFTC from regulating them as futures contracts and prohibiting the SEC from regulating them as securities. The CFMA rightly recognized that swaps are banking products. The issues addressed in the CFMA were very complex and required a substantial amount of time to negotiate and to draft.

The Banking Committee played a key role in creating legal certainty for swaps in its work, together with the cooperation of the Agriculture Committee, as evident in Titles III and IV of the CFMA.

The CFMA was adopted with broad bipartisan support, after careful consideration over a period of years by four Congressional Committees and with the active support of the Secretary of the Treasury, the Chair of the Board of Governors of the Federal Reserve, the Chair of the Commodity Futures Trading Commission, and the Chair of the Securities and Exchange Commission.

I am very concerned that we not undo the significant achievement of the CFMA that was largely based on the President's Working Group report entitled "Over-the-Counter Derivatives Market and the Commodities Exchange Act." That product was an excellent report produced during the Clinton Administration.

That is why on July 19 I sent a letter to the PWG requesting its new views on the draft Commodity Futures Trading Commission reauthorization bill that was being worked on by the Senate Agriculture Committee. Chairman Greenspan replied, as Senator Sarbanes has already indicated that, "the issues are complex and the potential for legislation to have unintended consequences, including uncertainty about the enforceability of legitimate transactions that do not involve fraud, is considerable." He went on to say, "Consequently, I believe it would be a mistake to enact legislation that has not been thoroughly evaluated by the PWG and by market participants that may be affected."

I am in complete agreement with that statement and would like to thank you, Mr. Chairman, for starting this process today, and Senator Sarbanes, for your long history of involvement and work with this. This is a very technical subject matter and we need to get it right.

It is my understanding that the PWG staff devoted much time and effort during the month of August to address these concerns. It is my hope that the PWG principals can come together in agreement on this important issue and I look forward to the witnesses' testimony today. If the PWG principals cannot reach agreement, then I will be very hesitant to make very significant changes to the CFMA during reauthorization. If the PWG principals reach consensus but still have reservations, then I think we need to think long and hard about how we proceed.

I am also very concerned that over the last 3 to 4 years there have been proposals for additional regulation of energy derivatives that is not warranted and would have changed the CFMA balance in reaction to certain market events. Fortunately, we were able to turn them back here in the Senate, but had they succeeded, I am concerned that those efforts would have unraveled the delicate and

highly negotiated balance, and frankly, would have adversely impacted our economy.

In fact, in several hearings, Chairman Greenspan, commenting on some of these proposals and their potential impact, indicated that they could have had a serious dampening impacts on the ability of our economy to respond in a timely and appropriate fashion to significant events. So we are dealing with very critical issues here.

No doubt we must make sure that those who would commit fraud in financial transactions are subject to very aggressive and effective regulation, and that they are capable of being identified, stopped, and punished, and I do not believe that there is anybody who would disagree with that.

But in our zeal to make sure that we accomplish that objective, I do not think that we want to create a disincentive for financial markets in this country to work, and to work in the smoothness and the effectiveness that they have been shown to be able to do in the past. We want to have financial tools available that will allow our economy to react swiftly and well, to allocate risk properly, and basically to keep us on the cutting edge of international competition.

Mr. Chairman, as we have discussed, it is my intention to hold a hearing in the Subcommittee on the International Trade and Finance on the regulation of futures based on financial instruments and other financial products. In recent years, trading in futures contracts has expanded rapidly beyond the traditional physical and agricultural commodities into a vast array of financial instruments, including foreign currencies, U.S. and foreign government securities, and U.S. and foreign stock indices.

I appreciate the Chairman's willingness to facilitate and support the Subcommittee's interest in this and look forward to holding that hearing.

Again, Mr. Chairman, I appreciate your attention to this issue and look forward to working with you as we move forward.

Chairman SHELBY. Thank you.

Senator Martinez.

#### COMMENTS OF SENATOR MEL MARTINEZ

Senator MARTINEZ. Mr. Chairman, Thank you very much. I want to thank you and Senator Sarbanes for this important hearing. I have a brief statement.

Chairman SHELBY. We all want to call you "Mr. Secretary," but we are getting used to you being up here.

[Laughter.]

Senator MARTINEZ. I have changed now. I am pleased to be here in this role, and I just want to submit a brief statement for the record.

Chairman SHELBY. Without objection, it will be made part of the record.

Senator MARTINEZ. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bunning.

### STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman. I have a short statement. I would like to just thank you for holding this hearing today, and Senator Sarbanes also, on the Commodity Futures Modernization Act, the CFMA reauthorization.

In 2000, we enacted the CFMA after a joint Committee hearings process involving the Banking Committee and the Agriculture Committee. The CFMA enacted the most significant amendment to the CEA and derivatives trading in 25 years. The CFMA provided for legal certainty and regulatory clarity for over-the-counter derivatives and a framework for trading security futures products. The provisions in the CFMA generally followed the recommendations contained in the report by the President's Working Group on Financial Markets. The CFMA worked because the two Committees worked together. Unfortunately, that is not the case this time.

I know the Chairman and Ranking Member have made their concerns well-known to the Agriculture Committee. I wish the Ag Committee would have worked with us to solve these problems. But the Ag Committee chose to go ahead and report their bill, despite this Committee's concerns. I believe that was a mistake. Now, we find ourselves with serious jurisdictional problems, problems I believe could have been worked out to both Committees' satisfaction.

I understand the Ag Committee's frustration with the lack of action by the SEC on many of the issues they tried to fix in S. 1566. Many of us on this Committee have felt similar frustrations with the SEC on other issues. It seems like no issue becomes a priority to the SEC unless a State official starts making headlines. I am confident this will change with Chris Cox as the new Chairman.

I hope this hearing and this process has gotten the SEC's attention. I hope these issues that have sat around for 5 years-plus now, will become priorities. I hope the SEC and the CFTC and the rest of the President's Working Group will continue to work together, I commend the staff of the group for coming up with an agreement to clarify the *Zelener* decision problems and allow the CFTC to protect retail investors. And finally, I hope, going forward, that the Ag Committee will work with this Committee, as we did in 2000 and pass a good bill that protects investors and help markets.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank all of you.

The panel's written testimony will be made part of the hearing record. If you would, sum up your strongest parts and your recommendations and observations. We will start with Secretary Quarles. Welcome to the Committee.

Oh, excuse me. Senator Hagel.

### COMMENTS OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, I thank you for holding this hearing today on such a timely topic. I just want to welcome all of the witnesses today and thank them for coming. I am sure we will benefit from their knowledge.

Chairman SHELBY. Okay. He wants to go to the panel. Thank you. Go ahead, Mr. Secretary.

**STATEMENT OF RANDY K. QUARLES  
UNDER SECRETARY FOR DOMESTIC FINANCE  
U.S. DEPARTMENT OF THE TREASURY**

Mr. QUARLES. Thank you, Chairman Shelby, Ranking Member Sarbanes, and other Members of the Committee. I will be very brief given that my written remarks will be included in the record.

As you know, the Secretary of the Treasury is the Chair of the President's Working Group. The other members of the President's Working Group are here with us. In recent weeks, the Working Group and members of the senior staff have met to discuss the effect of last year's Seventh Circuit Court of Appeals decision in *CFTC v. Zelener*, and the effect of that decision on the CFTC's anti-fraud authority, and in particular, the ability to address certain retail foreign exchange contracts.

We have produced a proposal that addresses the issues that were raised by the *Zelener* case, reflecting a consensus of the President's Working Group, while being very sensitive to preserve the careful compromises of the CFMA of 2000.

Let me just say at the outset that one of the important elements of this consensus is that we do not think that the modification that this proposal would produce should extend beyond retail foreign exchange to any other commodities. We think that major changes to the significant modernizations of the CFMA are not warranted. But one change that the CFMA did make was to modify the Commodity Exchange Act so that certain provisions of the Act, including anti-fraud provisions, did apply to foreign exchange futures and certain options with retail customers if the counterparty was not otherwise regulated.

Those changes were intended to provide the CFTC with tools to pursue fraud against retail customers by bucket shops offering certain foreign exchange contracts. What the *Zelener* case showed was that there were some weaknesses in the CFTC's ability to pursue this type of bucket shop fraud, but we think that with the work that we have done over the course of August, the proposal that we currently have here, that those weaknesses can be addressed without upsetting the compromises of the CFMA. They can be addressed in a very narrow way.

The changes that we are proposing would be, as I said, limited to cover only certain retail foreign exchange contracts that have been the subject of abuse. They would apply the CEA or its anti-fraud provisions to certain retail foreign currency futures and certain options and their sales chains when an FCM is involved. And they would apply the antifraud provisions to certain retail foreign exchange contracts that are not securities, that are not contracts that result in actual delivery within 2 days or certain contracts in connection with a line of business, as well as to their sales chains.

Our proposal makes futures transactions and certain options on foreign currency between a retail participant and a counterparty that is not an otherwise regulated entity, such as a financial institution, a broker-dealer, or an insurance company, subject to the CEA. It would provide the CFTC with antifraud jurisdiction over those retail foreign exchange contracts and the persons who engage in sales activity in connection with those contracts if the counterparty is an FCM. And any person who participated in the

solicitation or recommendation of such a contract within the FCM sales chain would register with the CFTC and be a member of a registered futures association. The PWG proposal would preserve the exclusion for otherwise regulated entities that was crafted by the CFMA.

This proposal would make certain foreign currency contracts between a retail participant and counterparty that is not otherwise regulated subject to CFTC antifraud jurisdiction if the contracts were leveraged, margined, or financed, except that they would not apply to, as I said, securities, contracts that result in actual delivery within 2 days, or certain contracts in connection with a line of business. It would make such retail foreign exchange contracts and the persons who engage in activity in connection with them subject to the antifraud provisions, and any person who participated in the solicitation or recommendation of such a contract would have to register with the CFTC and be a member of the NFA.

Let me move on and say just a few words then about the issues of portfolio-style margin systems and contracts and products based on narrow-based indices. The CFMA granted to the Board of Governors of the Federal Reserve System the authority to establish margin requirements for security futures products. The Board delegated that authority to the SEC and the CFTC jointly. The SEC and the CFTC are continuing to work toward permitting portfolio-style margin models. At the Treasury Department, we support the concept of portfolio-style margining systems. They increase the efficiency of capital allocation. They encourage risk management activities. We note some progress has been made very recently, and we remain hopeful that the SEC and the CFTC can work together to facilitate the implementation of these margining systems soon.

The CFMA also created a distinction between broad-based security indices, which have been regulated solely by the CFTC, and narrow-based security indices, which are regulated by the SEC and the CFTC jointly. The definition of "narrow-based security index" seems to have been formulated using criteria that are appropriate for equity securities as opposed to debt securities. And so in that context, the Treasury Department can support reviewing the appropriateness of certain criteria in this definition of "narrow-based security index" in the context of debt and foreign security index futures given that the nature of the underlying securities differs from domestic equities, which seems to have been what was the context of the development of the definition. And so we are supportive of that review.

In conclusion, I very much appreciate the opportunity to appear today to discuss these issues, present the consensus proposal of the President's Working Group. The proposal does provide the CFTC with the statutory enforcement authority that is necessary to combat fraud against retail customers while preserving what we think are the very important provisions of the CFMA and avoiding unintended consequences of overly broad changes.

I look forward to continuing to work with my colleagues from the President's Working Group and with Members of Congress on these issues, and I look forward to your questions.

Chairman SHELBY. Thank you, Secretary Quarles.

Mr. Colby.

**STATEMENT OF ROBERT L.D. COLBY  
DEPUTY DIRECTOR, DIVISION OF MARKET REGULATION  
U.S. SECURITIES AND EXCHANGE COMMISSION**

Mr. COLBY. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I am pleased to be here today to testify on behalf of the Securities and Exchange Commission. I will briefly summarize the Commission's views on the Commodity Exchange Reauthorization Act of 2005, which are more completely set forth in my written testimony.

There are three changes proposed by S. 1566 that I will discuss: First, the changes to the margin requirements for securities futures; second, the directive to change the definition of "narrow-based security index"; and, finally, the changes to the Commodity Exchange Act designed to address the Seventh Circuit decision's in *CFTC v. Zelener*.

The Commission supports the expansion portfolio margining to all equity products. We believe, however, that it can, and should, be accomplished without undermining the current requirements regarding comparability between security futures margin and options margin. Section 7 of S. 1566 would permit security futures margin to be calculated using a portfolio margining methodology, but would do so by removing the current requirements regarding comparability between security future margin and exchange-traded options margin. It would also eliminate the SEC's role in establishing margin requirements for security futures. The Commission strongly opposes these changes to the joint regulatory framework for security futures and believes that these changes would provide security futures a regulatory advantage over security options, products that are economic equivalents. The SEC believes that competition should be based on better products, services, and prices, not on regulatory differences.

We acknowledge that implementing portfolio margining has not been the Commission's top priority over the past few years and that it is time for more concrete action to implement portfolio margining. In this regard, Chairman Cox met recently with CFTC Chairman Jeffery and committed to make the expansion of portfolio margining a Commission priority. Already, on July 14, 2005, the SEC approved companion proposals by the New York Stock Exchange and the Chicago Board Options Exchange that permit their members, on a pilot basis, to compute certain customers' margin requirements using a portfolio margin methodology. These portfolio margin rules are limited, but the Commission staff has been actively discussing with the securities industry, CBOE, and New York Stock Exchange an approach to portfolio margining, including single stock futures, narrow-based securities index futures, and other equity securities.

The self-regulatory organizations, too, have reinvigorated their efforts to allow for risk-based portfolio margining, and we anticipate that the New York Stock Exchange and CBOE will propose to expand their portfolio margining pilot drawing from recommendations of a committee of representatives of securities firms.

Finally, we believe it would be helpful for legislation to make certain changes to the Securities Interview Protection Act of 1970, or SIPA. Such amendments could be targeted to provide that futures

held in a portfolio margin account to offset positions in related securities would receive SIPA protection in the event of bankruptcy. This type of change to SIPA would encourage customers to take full advantage of portfolio margining rules.

The Commission also has serious concerns about the amendments in Section 8 of S. 1566. These changes would potentially remove products currently considered securities from Commission oversight and eliminate key protections currently provided by the Federal securities laws to investors in futures based on such excluded indices. Also, if these indices were excluded from the definition, it would give the CFTC exclusive jurisdiction over futures on such indexes, and give futures exchanges the exclusive right to trade these products. Securities exchanges would be precluded from trading such instruments.

I would also like to note that Section 8 of S. 1566 introduces a subjective standard that the SEC and CFTC would be required to consider in assessing whether an index should be considered broad-based. One of the significant achievements of the CFMA was to establish clear, objective standards for which indexes were narrow and which were broad. We urge Congress not to reintroduce uncertainty into this area by establishing standards for determining jurisdictional boundaries that are subjective and subject to differing interpretations.

Finally, the Commission shares the concerns of this Committee's Chairman and Ranking Member, as well as other members of the Working Group, regarding the potential adverse consequences of the provisions in S. 1566 designed to address the Seventh Circuit decision in *CFTC v. Zelener*. The Commission is concerned that the changes proposed to be made to the CEA would compromise the legal certainty and regulatory clarity achieved by the CFMA.

In addition, S. 1566 would curtail the foreign currency exclusions from the CEA for the securities industry that were established by the CFMA. The Commission believes these changes would undermine the competitive parity between broker-dealers and banks in foreign currency transactions. There is no evidence of involvement in the retail foreign currency fraud by these currently excluded broker-dealer affiliates that would justify elimination of their exclusion. Instead, we think the *Zelener* decision just calls for fine-tuning of the Treasury Amendment. We stand with what Under Secretary Quarles has said, and we look forward to finalizing legislative language.

Thank you very much. I would be happy to answer any questions you may have.

Chairman SHELBY. Thank you.

Mr. McCarty.

**STATEMENT OF PATRICK J. McCARTY, GENERAL COUNSEL,  
COMMODITY FUTURES TRADING COMMISSION**

Mr. MCCARTY. Mr. Chairman and Senator Sarbanes, good morning. I am pleased to testify today on behalf of the Commodity Futures Trading Commission regarding the reauthorization of the Commodity Exchange Act.

The last such exercise by Congress resulted in the Commodity Futures Modernization Act of 2000, which truly was landmark leg-

isolation. This Committee deserves credit for its role in the drafting of that law. The CFTC concurs with the widely held view that the current reauthorization should involve only incremental changes to the Commodity Exchange Act.

Mr. Chairman, you asked us to comment on several issues, and I will begin with portfolio margining for security futures products. This is an important issue because we have heard from exchanges and market participants that the current margining scheme has been an impediment for traders to buy and sell SFP's. They are being traded quite successfully in other jurisdictions, including in Europe, and in the vast majority of foreign SFP markets, margin requirements are risk based.

I would note that the reauthorization bill reported by the Senate Ag Committee calls for a pilot program for risk-based portfolio margining of SFP's. That SFP pilot program would be similar to the CBOE portfolio margining pilot program that was approved by the SEC on July 14. The CBOE pilot program does not include SFP's. The CFTC strongly supports the concept of risk-based and portfolio margining for both security futures products and for security options. These types of margining, standard in the futures industry, are both efficient and effective from a regulatory point of view, and have been very successful in protecting customer funds.

The use of risk-based portfolio margining for financial products has received support in the past from the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission. Details are in my written testimony.

Mr. Chairman, regarding definitional changes for narrow-based security indexes, the current statutory tests enacted in the CFMA were based on the U.S. equity market, the largest, deepest, and most liquid market in the world. They are inappropriate for the smaller size in trading volume that generally characterizes foreign markets and debt markets. The CFMA gave the CFTC and the SEC authority to exclude certain foreign indexes and instruments from this narrow-based category. However, the agencies have not acted, thus preventing these new products from being made available to U.S. customers.

This is not a matter of altering the existing jurisdictional division between the SEC and the CFTC, but rather ensuring that foreign security indexes and debt security indexes may qualify to be traded in the United States under a test that more accurately takes into account the nature and size of these markets as the CFMA requires. The CFTC has developed specific definitions to achieve this end and they are set forth in my written testimony.

Finally, the issue that has received the most public attention involves the Commission's antifraud authority over retail foreign currency transactions in light of the recent *Zelener* court decision. Retail forex fraud from sales pitches with false assurances of guaranteed profits to outright absconding with customer funds has posed a significant enforcement challenge to our agency.

Since the CFMA was enacted, the CFTC has brought 79 enforcement actions in the retail forex sphere involving more than 23,000 victims, and court-ordered restitution and penalties of approximately \$267 million. I want to stress that the CFTC continues to believe the contracts at issue in *Zelener* were futures contracts. To

protect customers from fraud, our Division of Enforcement will continue to litigate similar cases aggressively.

As you are aware, there are a number of views as to how the *Zelener* decision should be addressed. Recognizing this, the President's Working Group on Financial Markets, of which CFTC Chairman Reuben Jeffery is a member, set out to develop a consensus position to recommend to the Congress. As Under Secretary Quarles of the Treasury has testified, the PWG members have reached agreement in concept. Final details are being worked out.

With respect to questions posed by the Committee, I can say the concept would be a narrow fix that applies only to futures and *Zelener* type contracts in foreign currency that are offered to retail customers. In addition, the concept retains the current otherwise regulated regime in which retail forex transactions by financial institutions, including banks, broker/dealers, and insurance companies, are excluded from the CFTC's jurisdiction.

We look forward to providing our authorizing committees and this Committee our recommendations when the detailed language has been finalized.

Thank you again, Mr. Chairman, and I am prepared to answer your questions.

Chairman SHELBY. Mr. Parkinson.

**STATEMENT OF PATRICK M. PARKINSON  
DEPUTY DIRECTOR, DIVISION OF RESEARCH AND STATISTICS  
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Mr. PARKINSON. Chairman Shelby, Senator Sarbanes, and Members of the Committee, thank you for the opportunity to testify on the CFMA and on regulatory issues that have arisen in the context of the reauthorization of the CFTC.

The Federal Reserve Board believes the CFMA has unquestionably been a successful piece of legislation. The CFMA has made our financial system and our economy more flexible and resilient by facilitating the transfer and dispersion of risk. Consequently, the Board believes that major amendments to the regulatory framework established by the CFMA are unnecessary and unwise.

Nonetheless, the Board supports some targeted amendments to the CEA to address persistent problems with fraud and retail foreign currency transactions and to facilitate the trading of security futures products and futures on security indexes.

In its 1999 report, the PWG concluded that to address problems associated with foreign currency bucket shops, the CEA should be applied to transactions in foreign currency futures if they are entered into between a retail customer and an entity that is neither federally regulated nor affiliated with a federally regulated entity.

The CFMA included provisions that were largely consistent with the PWG's recommendation.

The CFMA has allowed the CFTC to take numerous enforcement actions against retail foreign currency fraud. However, the CFTC has continued to encounter certain difficulties in this area. The Board supports targeted amendments to the CEA that address the specific difficulties that the CFTC has encountered. However, it is critical that those amendments be carefully crafted to avoid creating legal or regulatory uncertainty for legitimate businesses pro-

viding foreign exchange services to retail clients. The Board would be opposed to extending any new CFTC authority to retail transactions in other commodities without further careful consideration and demonstrated need. Provisions crafted to avoid creating uncertainty for legitimate foreign currency businesses are unlikely to provide the same protection to a much wider range of businesses.

The agreement in principle that has been reached by the PWG appears to be fully consistent with the Board's views and therefore deserving of its support.

Turning to portfolio margins, the CFMA gave the Board authority to prescribe regulations establishing initial and maintenance margins for security futures products or to delegate that authority jointly to the CFTC and the SEC. The Board delegated its authority to the Commissions in a letter dated March 6, 2001. The Board has supported the use of portfolio margining for some time. For example, in 1998 the Board amended its Regulation T to allow securities exchanges to develop portfolio margining as an alternative to strategy-based margining subject to SEC approval.

In its 2001 letter delegating its authority over margins for security futures jointly to the CFTC and SEC, the Board requested that the Commissions report to the Board annually on their experience, exercising the delegated authority, and in particular to include in those reports an assessment of progress toward portfolio margining for security futures products.

Unfortunately, to date, no progress has been made toward portfolio margining of security futures products. Because the CFMA stipulates that margin requirements for security futures products must be consistent with margin requirements on comparable security options, progress for security futures requires progress on options. Although margin requirements for options have for many years been portfolio based at the clearing level, customer margins were, until very recently, strictly strategy based.

However, in July the SEC approved rule changes that create a 2-year pilot program that would permit portfolio margining of options and futures positions in broad-based stock indexes held by certain customers with very large accounts. If this pilot program were adopted as a margining system available to all customers for a broad range of products, significant progress toward portfolio margining security futures products would become possible.

The Board believes that it is appropriate for the Congress to spur progress toward portfolio margining for security futures. For example, the Congress could spur progress for both security futures products and options by requiring the Commissions to jointly adopt regulations permitting the use of risk-based portfolio margining requirements for securities futures products within a short reasonable time period, and requiring the SEC to approve risk-based portfolio margin requirements for options within the same period.

Finally, some futures exchanges argue that the definition of a narrow-based index in the CFMA was drafted with reference to the U.S. equities markets, and that in any event the definition unnecessarily restricts the trading of futures on indexes of U.S. debt obligations and foreign securities. Although the Board has not had a strong interest in this issue, it favors taking another look at the

appropriateness of applying the existing definition to indexes of foreign securities.

First, for many years several futures on foreign equity indexes have been trading abroad and have been offered to customers in the United States. Although these indexes would be considered narrow-based indexes under the existing definition, we see no evidence that these indexes have been susceptible to manipulation.

Second, the provision in the 2005 Reauthorization Act can be seen as simply reiterating an existing requirement in the CFMA that the CFTC and the SEC jointly adopt rules that define narrow-based indexes based on foreign securities.

That concludes my prepared remarks. Thank you.

Chairman SHELBY. I think I have about four questions. Other people have more. The futures markets continue to evolve, as we all know, as an increasing number of future contracts are based on financial instruments. It seems increasingly likely that exchanges will soon seek to trade both securities and future products.

As a result of this market convergence, the differences between securities and futures becomes less clear. In light of these developments here, does the regulatory regime need to be modernized to reflect current market realities? Does the current regulatory scheme that draws a line between futures regulation and regulation for other financial products make sense? Secretary Quarles, do you want to comment first?

Mr. QUARLES. That is a thoughtful question. The official sector always needs to be very mindful of changes that are happening in markets and in the structure of industries that affect changes in market—

Chairman SHELBY. Is the market getting ahead of the regulatory regime?

Mr. QUARLES. We need to make sure that the regulatory framework is reflecting what is actually happening in practice. I think that that requires further reflection. I would not be prepared today to make specific recommendations in light of that, but having recently been sworn into this job, that theme is something that I am asking my people at the Treasury Department to be focused on, is ensuring that changes in the industry over the last 5, 10 years, changes and the effects on markets that those changes in the structure of the industry might be having, that we are thinking about appropriate policy responses. Today, I would not be prepared to recommend any particular ones, but that is a theme that we are definitely pursuing.

Chairman SHELBY. Mr. Colby, you have any comment?

Mr. COLBY. Chairman Shelby, this is an issue that has been of acute interest to the Commission over the years. We deal with the ramifications of this very important issue on a daily basis. Our new Chairman, however, has not had time to focus on this crucial issue, so I would like to defer answering the question.

Chairman SHELBY. Mr. McCarty, you have a different view?

[Laughter.]

Mr. MCCARTY. No. I think I will have to defer to get an answer from our Chairman.

But I think your observation is absolutely correct. There seems to be a convergence occurring over the last several years. The

CFMA has worked extremely well, and I would say that the regulatory structure has seen the markets and helped them develop. I think that convergence is a big issue that is coming.

Chairman SHELBY. Mr. Parkinson, do you have a comment?

Mr. PARKINSON. I think the distinctions between securities and futures have been blurring, and where they exist they are often arbitrary—based on legal distinctions rather than economic differences. But having encountered this question several times over the years, I do not think one should underestimate the difficulty of developing a new regulatory structure that improves on the existing one.

For example, some seem to think that simply merging the CFTC and SEC would solve all these problems, but I think that, by itself, would not achieve consistent regulation of securities and futures. The fact is that the underlying statutes the CEA and the 34 Act, provide for quite different approaches to regulation. Moreover, if OTC derivatives come into the picture here, they are neither futures nor securities, and in our view are not appropriately regulated as either. In that case, private market discipline rather than Government regulation is really the critical mechanism ensuring that public policy objectives are met.

Again, much as I can understand the frustrations with the existing regime, I think it is going to be difficult to come up with a better one.

Chairman SHELBY. The product is not a security, per se, and it is not a futures, per se. Is it a hybrid? Is it something that man has invented and is very resourceful?

Mr. PARKINSON. At the insistence of this Committee, the CFMA explicitly identifies a class of products called banking products that are neither securities nor futures nor regulated as either. So that is an example.

Chairman SHELBY. It seems that there is agreement among the witnesses that portfolio margining is a positive step for not only security futures but also for security options. There seems to be consensus on this point. To date, the regulators have been unable to produce a rule adopting portfolio margining. Given this inaction, should Congress mandate that the regulators adopt portfolio margining for security futures and security options? If not, then what assurances does Congress have that it will be done in a timely manner?

Mr. Colby.

Mr. COLBY. I recognize first of all that this issue has been a long time in coming. I believe that we are on the cusp of moving much more quickly to address portfolio margining. We have a framework now established in the pilot program that was set up by the CBOE and New York Stock Exchange. The NYSE and the CBOE, I believe, are reenergized in order to move this forward.

We have a consensus in the industry about a way to move forward, and so I do not think the issue merits legislation. If there were legislation, I think it would remain important that the margin requirements be determined by the SRO's who bring the expertise of the industry and the ability to work on the issues and find a workable and inexpensive way to do it, subject to the approval of the CFTC and the Commission.

Chairman SHELBY. Secretary Quarles, you have a different view?

Mr. QUARLES. No. I think, as I indicated in my testimony, I think we are beginning to see progress.

Chairman SHELBY. What about you, Mr. McCarty, you have a different view than the SEC?

Mr. MCCARTY. I think that it has been a long time coming, and I guess our point of view is we would like to work with the SEC to get this done as quickly as possible. I would note however that there is nothing like a statutory deadline to get one to move.

Chairman SHELBY. Mr. Parkinson.

Mr. PARKINSON. As I indicated in my testimony, the Board believes it is appropriate for Congress to spur progress here, both in the case of security futures and security options. The step that the SEC took recently was a very important one, but as you have indicated, it was a long time in coming, and I think the concern of people in industry is that we not come to the next CFTC reauthorization and see that there still has not been meaningful progress.

Chairman SHELBY. Some have proposed that Congress should direct the regulators to amend the definition of what we call narrow-based security indexes to account for debt and foreign securities. Do the SEC and the CFTC currently have the necessary statutory authority to modify this term or is legislation necessary?

Mr. Colby.

Mr. COLBY. We absolutely have the necessary authority to—

Chairman SHELBY. Without question?

Mr. COLBY. Without question. And we have in the past excluded some indices from the definition narrow-based volatility indexes that are—

Chairman SHELBY. If you have the authority, what are you going to do about it?

Mr. COLBY. Yes, that is a fair question. Our plan is to work closely with the CFTC to address each of these issues. Some of them are new to us. The debt issue has not previously been presented to us before this legislation. The foreign securities issue is familiar. The debt issue is new.

Chairman SHELBY. Can you afford to let the market get ahead of you as a regulator? Both of you. In a sense you cannot, can you?

Mr. COLBY. We never want the market to get ahead of us. I think we can work with the CFTC to make real progress here.

Chairman SHELBY. Secretary Quarles and Mr. Parkinson, would you please comment briefly on changes to the definition of narrow-based security index? In other words, can the members of the Working Group here resolve this issue, or does Congress need to step in? What do you think, Secretary Quarles and Mr. Parkinson? The Treasury and the Fed play a role here.

Mr. QUARLES. If you are asking is it appropriate for the Working Group to have on its agenda this issue. It is the issue that the Working Group can consider. I do think that the SEC and the CFTC obviously have the principal expertise here, and so I do not know that it is necessary that it become an agenda item. Certainly if it was the desire of this Committee that it become one—

Chairman SHELBY. If they have the expertise, which I do not question, if they have the statutory authority, they need acceleration perhaps in doing something?

Mr. QUARLES. The Working Group has been in the past an accelerating device.

[Laughter.]

Chairman SHELBY. Senator Crapo, you spent a lot of time on these issues.

Senator CRAPO. Thank you very much, Mr. Chairman. I have been checking off my questions as you asked them, but I still have a couple of others.

I want to go into what I understand to be the consensus position that the Working Group is prepared to submit with regard to the *Zelener* decision. Let me clarify, it is my understanding that we have a consensus position in concept, but we do not have specific language; is that correct?

Mr. QUARLES. That is correct, but there has been a very substantial element that remains to have final language done, so this is not just concept.

Senator CRAPO. And the only area on which we have consensus at this point is the matter of dealing with the *Zelener* decision. I mean there are other issues that the Working Group is working on, I understand, and I understand there is not necessarily a consensus position on other issues. Is that correct?

Mr. QUARLES. We have begun with the *Zelener* issue, so it is not as though we have been considering the other issues and have reached any impasse. It is that as a working procedure we began with the *Zelener* issue and completed that agreement, and the time that that took, took the time until this hearing.

Senator CRAPO. That is a good clarification and I appreciate that. I know that each of you in your testimony have basically said this already, but I want to nail it down, and that is that my understanding is that the consensus that has been developed is that the fraud issues dealing with retail foreign currency transactions that were raised by the *Zelener* case can be handled with a narrow anti-fraud fix that does not expand the jurisdiction of the Act otherwise, a narrow antifraud fix dealing with retail foreign currency transactions specifically; is that correct? Everybody is nodding their head yes.

Mr. QUARLES. Yes, it is.

Senator CRAPO. So the record can reflect that at least the Working Group is in consensus, that a narrow fix is all that is necessary and can accomplish the objectives necessary to deal with the fraud issues?

Mr. QUARLES. That is correct.

Senator CRAPO. Let me ask a question then about the rest of the agenda. It is clear to me that the fraud issues were one that we needed to deal with. The *Zelener* case brought this to the forefront and the concern about the potential fraud, particularly in retail foreign currency transactions, required some action, and there is now consensus in terms of how we should approach that, at least from the Working Group. Are there other areas such as the *Zelener* case or the retail fraud issues that we just discussed, that Congress needs to talk about, or is the *Zelener* case really the area that we need to focus on? Are there other problem areas that require statutory solutions right now?

Mr. COLBY. As I mentioned in my testimony, there is a small amendment to the Securities Investor Protection Act that we think would facilitate cross-margining, which we would be happy to transmit to you for your consideration. The aim of it is to protect futures that are in a cross-margin account under the Securities Investor Protection Act so you do not run the risk of insolvency where part of the account will be protected and part of it will not.

Senator CRAPO. Any others? Yes, Mr. McCarty.

Mr. MCCARTY. Senator Crapo, we had two other provisions in our testimony dealing with fraud authority. One is with respect to clarifying that we have principal-to-principal fraud authority under our Section 4(b) provision. This is a very important issue for us, and we can discuss it later on, but it is a very important part of the Senate bill.

The second item is clarification of our civil and administrative authority to bring actions under Section 9 of our Act. Those two provisions are actually in the Senate bill and they are quite important to the Commission.

Senator CRAPO. Any others?

Mr. PARKINSON. As we indicated, we do support the Congress taking steps to spur progress on portfolio margining, and I think less strongly we would support doing something to move forward on the narrow-based index question as well.

Senator CRAPO. But in that context you are talking about more deadline setting rather than Congress establishing those substantive changes?

Mr. PARKINSON. That is correct. I think Congress would not want to take on the question of redrawing the narrow-based index definition, for example, which is extremely complex.

Senator CRAPO. Mr. McCarty.

Mr. MCCARTY. If I might come back to that issue just briefly. One, I think that we clearly have the statutory authority, as the Chairman suggested, the SEC and ourselves at the CFTC, to work out exceptions from the narrow-based index definition. We have some proposed definitions that we have supplied in our testimony. There may be a difference of opinion between the two staffs as to exactly where Congress—what their intentions were and were not about the scope of those exceptions that we might make from the narrow-based security index definition. That is one thing that we may need to talk to you or your staffs about to get a clear focus on exactly how to fulfill Congress's intent in terms of what you would like to exclude.

Senator CRAPO. Anything else? I am trying to just get the water-front laid out here so we know what we want to look at.

Just one last question of the panel, Mr. Chairman.

Chairman SHELBY. Go ahead.

Senator CRAPO. And that is, Mr. McCarty, you raised Section 9 of the Agriculture Committee's bill as a matter that you feel did address some important issues that you need to deal with. In the context of legal certainty for swaps, one of the issues that was addressed by this Committee was the creation of legal certainty for swaps in the legislation. Sections 2(g), 2(h), and 2(i) in the Act were included specifically to establish this legal certainty.

As I read at least the report language and my understanding of the bill's language itself that the Senate Agriculture Committee just put out, it would adversely affect these or significantly change these sections, in that the report states that the CFTC believes that Section 9 dealing with false reporting applies to excluded transactions, even though the statute currently specifically states that nothing in that section applies to these swap transactions.

So the question I have is: If Section 9 applies to any excluded transactions, would this not cover securities and mortgage finance as well as OTC swaps, and does this not undermine the legal certainty for swaps that was established in the original Act?

Mr. MCCARTY. Senator, I think what you are referring to here is the false reporting cases that we have brought. Our Section 9 authority actually has many aspects to it. One is where people supply knowingly false reports in an attempt to manipulate commodity indexes and prices. We have always taken the position that the 2(g) and 2(h) exclusion and exemption apply to the contracts themselves. We are not actually saying that our Section 9 authority brings those contacts back in. The distinction that we make is that those contacts are clearly excluded from our jurisdiction except when someone, like an energy company, would report falsely or make up transactions and report them to index providers, publishers, in an attempt to manipulate those commodity prices.

We just had a very significant victory in the Northern District of Oklahoma in the *Bradley* case. In *Bradley*, the Federal District Court agreed with the CFTC that in fact while the 2(g) and 2(h) provisions exclude the contracts transactions and their legal certainty is assured, the act of false reporting those transactions is a separate act. No one is required, who engages in a transaction under 2(g) or 2(h), to report those transactions to anyone.

Chairman SHELBY. That is correct.

Mr. MCCARTY. What we found in the *Bradley* case is that hundreds of false reports were submitted to the index providers in an attempt to benefit positions that the energy traders had.

Senator CRAPO. Have you been successful in asserting jurisdiction over that false reporting?

Mr. MCCARTY. Yes, sir. August 1 of this year, the U.S. Federal District Court for the Northern District of Oklahoma in *Bradley* agreed with our long-held position that false reporting is a separate act from the actual exclusion of the transactions under 2(g) and 2(h).

Senator CRAPO. Would there need to be any statutory change since you have already successfully asserted that?

Mr. MCCARTY. Senator, yes, we still do need the change that has been agreed to with the industry. That language is in the Senate Ag bill. It is needed to clarify the language in Section 9 which looks as if it applies only to felonies. We want to make sure that it clearly applies to our civil and administrative actions.

Senator CRAPO. But you are not seeking to extend the reach of the Act to anything beyond what you have already done I these enforcement actions?

Mr. MCCARTY. That is absolutely correct, Senator.

Senator CRAPO. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Crapo.

I will direct this question to Secretary Quarles and Mr. Colby. It seems that the Working Group is developing a proposal regarding registration requirements for certain counterparties engaged in the sale of retail foreign exchange contracts. How would such registration requirements apply to broker/dealers and their affiliates? Secretary Quarles?

Mr. QUARLES. They would not apply.

Chairman SHELBY. Do you have the same opinion?

Mr. COLBY. I certainly hope so.

[Laughter.]

Chairman SHELBY. You hope so.

Mr. COLBY. My understanding is they would not apply, that is right.

Chairman SHELBY. I want to thank the first panel here—we have another panel—for your appearance this morning. It seems to me here that the Working Group has developed a consensus position regarding the regulatory ambiguity arising from the *Zelener* case, as Senator Crapo referred to. If I am wrong, you tell me.

While I am encouraged by this positive result, or seemingly so, I would request that the Working Group continue to meet, hopefully over the coming weeks, regarding portfolio margining and definitional changes to the term “narrow-based security indexes.” As in 2000, consensus from the President’s Working Group would be extremely constructive to this Committee, to our process, and I believe it is critical to advancing any CFTC reauthorization legislation through the Senate. I hope that the Working Group will report back to this Committee with recommendations and proposed legislative language regarding the issues that we have discussed here this morning. We know they are complex, but you deal with complex issues.

I would also ask that you consult with the Committee staff here, as you have, as to when you might bring forth such recommendations.

We would also look forward to working, as always, with our colleague Senator Crapo, who has put so much effort into this, as he considers the regulatory scheme for futures based on financial instruments and other financial products at an upcoming Subcommittee hearing that he mentioned earlier. Senator Crapo, as we have acknowledged here—I have and Senator Sarbanes—has been a leader on this issue, has spent a lot of time on this issue, and I think his upcoming hearing will further inform the Senate as we consider the CFTC reauthorization. I hope you all will be forthcoming soon.

Thank you very much.

Senator CRAPO. Mr. Chairman.

Chairman SHELBY. Yes.

Senator CRAPO. Could I ask one more real quick question?

Chairman SHELBY. Go ahead.

Senator CRAPO. I apologize for that. This is for everybody on the panel. As you know, in the past, the President’s Working Group has explained why proposals that we have faced in the last couple of years for additional regulation of energy derivatives were not warranted, and the panel has unanimously urged Congress to be

aware of the potential unintended consequences of those proposals. Is that still true today? I have not heard anybody discuss bringing that issue back up today and I just wanted to be clear that there is agreement that that does not need to be addressed.

Mr. QUARLES. That is correct.

Mr. COLBY. Our view has not changed.

Senator CRAPO. And one other aspect of that: Would that also apply to natural gas derivatives; any reason for us to try to start jumping into changing the dynamic for regulating derivatives in the energy markets of any kind?

Mr. QUARLES. Not at this time.

Mr. COLBY. We agree.

Senator CRAPO. Thank you. I want the record to show that the answer was no from all members of the panel.

Chairman SHELBY. The record will so show.

Thank you very much.

Our second panel—I introduced them earlier, but I will do it again for the record. Mr. Charles Carey, Chairman of the Chicago Board of Trade, Mr. John Damgard, President, Futures Industry Association; Mr. Terrence Duffy, Chairman, Chicago Mercantile Exchange; Mr. Meyer Frucher, Chairman and Chief Executive Officer of the Philadelphia Stock Exchange; Mr. Mark Lackritz, President, Securities Industry of America; Mr. Robert Pickel, Executive Director and Chief Executive Officer of the International Swaps and Derivatives Association; and Mr. Daniel Roth, President, National Futures Association.

If the second panel will make their way to the table. As I said before, your written testimony is made part of the record, the hearing record, without objection, and if I could ask you to sum up your pertinent points, your strongest points that you want to make, as brief as you can, we would be very appreciative.

Mr. Carey, we will start with you if you are ready, and welcome to the Committee, all of you.

#### **STATEMENT OF CHARLES P. CAREY CHAIRMAN OF THE BOARD, CHICAGO BOARD OF TRADE**

Mr. CAREY. Mr. Chairman and Members of the Committee, my name is Charlie Carey and I am Chairman of the Chicago Board of Trade, the oldest and one of the largest futures exchanges in the world. Thank you for allowing me to appear before you today. I have also submitted written testimony for the record for the consideration of the Committee.

The CBOT thanks and congratulates the Congress for the passage of the Commodity Futures Modernization Act of 2000. The CFMA provided for increased competition and legal certainty in the derivatives industry, and reduced many unnecessary and costly regulatory burdens. Overall, it has been a great success.

Unfortunately, some of the goals and promises of the CFMA have not been fully realized. Dual regulation and inefficient margining have contributed to an environment that has inhibited the development of a robust, single-stock futures industry. Regulatory confusion may be keeping other innovations from the market. And an unfortunate court decision has been issued, which if not addressed, raises the specter of increased fraud. The Seventh Circuit Court of

Appeals in Chicago rendered an opinion in the recent *CFTC v. Zelener* case, which essentially does away with previously settled law setting out characteristics of a futures contract. By determining that the contracts in question were not futures because they did not include a guaranteed right of offset, this decision provides a road map for potential wrongdoers to offer fraudulent transactions outside the reach of the CFTC.

Such fraud involving commodities has the potential of tarnishing the reputations of exchanges, firms, and individuals who engage in legitimate business activities in the futures and derivatives industry.

When Congress passed the CFMA, it recognized that persons who did not meet the criteria for becoming eligible contract participants still needed the protection of Federal regulation by the CFTC if they dealt in commodity futures. Yet still, these retail investors are being solicited by telephone, Internet, and television pitches to invest in fraudulent deals involving foreign currency, heating oil, gold, and other commodities. CBOT urges Congress to enact an amendment giving the CFTC the authority to shut down fraudulent operators before this activity results in the loss of hard-earned savings of the investing public.

We believe that a solution that only addresses foreign currency transactions will not solve the problems created by this decision but merely shift them to other commodities.

In addition to clarifying law to protect the public from ongoing and future fraud due to the Court's decision in the *Zelener* case, the CBOT hopes that Congress will also continue the goal of reducing regulatory barriers to innovation in two areas. First, the CBOT asks that Congress consider clarifying that the definition of "narrow-based security indexes" does not include indexes on fixed income securities, corporate bonds, and other nonequity securities. The present definition creates a series of tests to distinguish narrow-based indexes from broad-based indexes. These tests are only workable for indexes on U.S. equity securities. Index products based on nonequity securities do not implicate the same regulatory concerns that led to the creation of the definition and test.

However, the possibility that the definition could be interpreted to cover nonequity products has hampered development of such products due to confusion as to what regulations may or may not apply. Clarification of this definition is an important issue that deserves to be addressed at this time.

Second, the CBOT asks the Congress to address the present inefficient and noneconomic margin requirements which continue to stymie growth of single-stock futures in this country while they flourish overseas. The CBOT hopes Congress will take this opportunity to facilitate the margining of stock futures as futures contracts, recognizing that the economic function of a futures contract is not to acquire ownership of the stock, but rather to act as a hedging vehicle.

The Chicago Board of Trade, along with all other U.S. exchanges, vigorously competes in the international marketplace. We ask Congress and this Committee to remain cognizant of the continued need to reduce unnecessary regulatory complexities that inhibit the

ability of U.S. exchanges to compete effectively with their counterparts around the world.

We also ask the Congress to give the CFTC the tools necessary to prevent peripheral scandals that have the potential of harming the U.S. derivatives industry.

Once again, the CBOT thanks the Committee for this opportunity and I am happy to answer any questions the Committee may have.

Chairman SHELBY. Thank you.

Mr. Damgard.

**STATEMENT OF JOHN M. DAMGARD  
PRESIDENT, FUTURES INDUSTRY ASSOCIATION**

Mr. DAMGARD. Good morning, Mr. Chairman. Thank you, Senator Crapo, for inviting me to testify.

I am John Damgard, President of the Futures Industry Association. The FIA's regular members comprise the largest futures brokerage firms, called Futures Commission Merchants, and its other members come from all segments of the futures industry. Thank you very much for the opportunity to present our views.

Both the CFMA and the CFTC have worked well, and we believe the CFTC should be reauthorized. Only two areas of the CFMA need discussion: Retail FX transactions and security futures. For retail FX, the issue is sales fraud. In recent years, the CFTC has devoted considerable resources to prosecuting firms for defrauding the retail public in FX transactions. Some have sought a major change in this area, which would grant the CFTC general jurisdiction over nonfutures FX transactions. They argue that because the CFTC lost one case, the *Zelener* case, the CFTC needs general jurisdiction over nonfutures retail FX or even other commodities.

FIA believes that would be a serious mistake. Just as the SEC was set up to regulate securities, the CFTC was set up to regulate futures. Expanding the CFTC's regulatory mission to nonfutures would be unwise and unnecessary. A better approach would be to address the fraud problem head on. In my testimony last March, FIA recommended that Congress grant the CFTC special fraud authority to move against unregulated firms that purvey retail FX transactions even if not futures. We still support that reform.

FIA also recommends making changes to CFMA's provisions for retail FX futures. As detailed in my written statement, FIA supports prohibiting shell FCM's from becoming qualifying counterparties to retail customers, registering those who solicit orders from retail customers, imposing special net capital levels on FCM's whose affiliates seek to qualify as counterparties, subjecting those qualifying affiliates to CFTC recordkeeping and reporting rules, and expanding the CFTC's enforcement powers to cover principal to principal fraud.

These important measures should give the CFTC the tools to curb the retail fraud scams that we have seen in recent years.

In security futures, FIA has one overriding goal. We want U.S. investors to have access to a full menu of innovative liquid and capital efficient markets for managing their security price risk. Allowing portfolio margining for U.S. security futures, that is, futures on individual stocks and narrow-based security indexes, would

serve that goal. It is true that the U.S. securities futures markets are not as well-developed as foreign markets. But portfolio margining will help our markets grow through more efficient use of trading capital under well-tested systems long in use by the futures industry.

We strongly urge the CFTC and the SEC to allow portfolio margining to be implemented without delay for security futures.

FIA also would encourage the SEC to move quickly on similar systems for the cash and options markets that it regulates. Anything that this Committee could do to help bring about portfolio margining would be gratefully appreciated.

Foreign security futures products is another area where congressional attention is warranted. Right now U.S. institutional investors are prohibited from trading foreign security futures products. CFTC and the SEC could lift this ban, but thus far no action has been taken. The result is that U.S. investors, including Federal Government employee pension funds, earn different and usually lower rates of return than their foreign counterparts who do have access to these foreign security products. Again, we ask for the Committee's help to rectify this disparity.

This handicap could also be reduced if the CFTC and the SEC adopted a targeted criteria for determining when foreign security indexes are narrow or broad. If an index is broad-based and the subject of a futures contract, it may be traded by U.S. investors; if narrow-based it may not be. Many diverse foreign security indexes, some with over 200 stocks, would not qualify under the CFMA's narrow-based index criteria. Yet many of these foreign indexes pose no threat of being used as a surrogate for trading an individual stock. This Committee could encourage the CFTC and the SEC to address this issue so that U.S. investors will have access to more products for managing their foreign equity price risk.

Thank you for your time and attention to these issues, and we look forward to working with the Committee on this legislation.

Chairman SHELBY. Thank you.

Mr. Duffy.

**STATEMENT OF TERRENCE A. DUFFY, CHAIRMAN,  
CHICAGO MERCANTILE EXCHANGE HOLDINGS, INC.**

Mr. DUFFY. Thank you, Chairman Shelby and Senator Crapo. I am Terry Duffy. I am the Chairman of Chicago Mercantile Exchange Holdings, Incorporated, which owns and operates the largest U.S. futures exchange, and by most standards, the largest futures exchange in the world.

This hearing permits the Committee to consider whether the Commodity Futures Modernization Act of 2000 has lived up to its promise. I want to use this time to explain the CME's suggestions for extending the positive impact of CFMA.

First, I urge this Committee to direct the SEC and the CFTC to exercise their statutory authority, to permit U.S. futures markets to implement genuine risk-based margining for securities futures products and to fully participate in the worldwide market for futures trading in broad-based indexes.

Second, we urge that the Commodity Exchange Act be amended to stop the explosion of off-exchange, retail futures fraud, and to

close the *Zelener* loophole, which is being exploited to avoid CFTC jurisdiction. I am confident that our solutions cause no harm, competitive or otherwise, to any customer or to the marketplace itself.

In my Congressional testimony of June 2003, I characterized single-stock futures as the CFMA's unfulfilled promise. I am sad to say what was true then remains so even today. The success of single-stock futures in European markets proves the value of the product. In this country, inter-exchange competitive concerns, combined with regulatory turf contests, largely mitigated the hope for this product long before it was launched. The regulatory system that has slowly evolved between the SEC and the CFTC has not addressed key issues. Several of the regulations that have been produced thus far are overly burdensome or inflexible.

We are not asking to undo the CFMA. We are only asking that the CFTC and the SEC be directed to do exactly what was contemplated by Congress when the CFMA was enacted. That is to jointly issue regulations to permit risk-based portfolio margining. This will put U.S. markets on par with financially sophisticated markets throughout the world. No one disagrees that risk-based margining is the world standard.

Any opposition to CME's proposal is based on ill-conceived notions of competitive parity. This claim is baseless. The average daily trading volume on options exchanges is 5 to 6 million contracts per day. One single-stock futures exchange has already failed, and the other trades about 6,000 contracts per day. The opponents of relief want Congress to suppress a potential competitor because they have been unable to get regulatory relief. The CME does not oppose equivalent relief for the securities options exchanges.

The CFMA defined one class of broad-based security indexes and left it to the agencies to jointly create an inclusive definition. The agencies have not done so. As a result, futures exchanges and U.S. Futures Commission Merchants have been unable to provide their customers with broad-based indexes on U.S. debt obligations, foreign debt obligations, and foreign equity securities.

The CFTC, the futures exchanges, and FIA are in agreement in principle that this should be fixed now. Our proposal requires the agencies to adopt a broad-based index definition that will fill in the statutory void that the agencies left unattended for the past 5 years.

The last point I want to talk about is off-exchange, retail futures trading. Off-exchange promotion of futures contracts to retail customers is a continuing source of harm to consumers. Just over the last 4 years of the CFMA, the CFTC has brought 79 enforcement actions involving 267 companies and individuals for illegal retail foreign exchange trading. The CFTC estimates that these cases involve trading with over 20,000 customers, and resulted in over \$260 million in penalties and restitution orders. This is just the tip of the iceberg.

The massive continuing fraud committed against retail customers in the OTC foreign exchange market, and the recent unfortunate decision of the Seventh Circuit Court of Appeals in *CFTC v. Zelener*, compel this industry to reexamine the public policy of how the CFMA addresses retail foreign exchange futures and the

threshold definition of what transactions should be subject to CFTC jurisdiction. The *Zelener* case held that the CFTC jurisdiction is avoided if the contract does not guarantee a right of offset. This was a surprising result since futures contracts traded at our exchange do not guarantee a right of offset.

The bucket shops have already figured out that the rationale of the *Zelener* opinion can apply to commodities other than FX. Heating oil and unleaded gas appear to be the hot targets as a result of the price run-ups in those commodities. How soon will it be before the CFTC's jurisdiction and its retail consumer protections are reduced to irrelevance?

Our *Zelener* fix puts the crooks out of business before they take the money and run, and it protects the public against the fraudulent oil and orange juice scams that will replace currency scams if the legislative response is limited to foreign exchange scams. It does not interfere with any legitimate business operation. CME believes that the law should be returned to its pre-*Zelener* status. A futures contract has always included leveraged, speculative contracts for future delivery sold to retail customers. All pertinent registration and other customer protection provisions should apply to such transactions.

Congress faces the challenge of adapting the CEA to an ever-changing world to assure the efficiency, competitiveness, and fairness of U.S. futures markets.

The CME looks forward to working with the Banking Committee to produce legislation that meets that objective. I thank you very much for your time.

Chairman SHELBY. Thank you, Mr. Duffy.  
Mr. Frucher.

**STATEMENT OF MEYER S. FRUCHER  
CHAIRMAN AND CHIEF EXECUTIVE OFFICER,  
PHILADELPHIA STOCK EXCHANGE**

Mr. FRUCHER. Thank you very much, Mr. Chairman, Senator Crapo. Thank you very much for having this hearing. This is very important to the industry.

I testify today, not just on behalf of the Philadelphia Stock Exchange, but also on behalf of the five other U.S. securities markets that trade options, namely the American Stock Exchange, the Boston Options Exchange, the CBOE, ISE, and the Pacific Exchange, as well as on behalf of our clearinghouse, the Options Clearing Corporation.

Securities options, that is, options on individual stocks and on broad-based stock indexes, play an important role in the U.S. financial system. U.S. options exchanges offer market participants a liquid, low-cost opportunity to hedge positions held in the cash markets. Market participants have been embracing exchange traded security options in record numbers in recent years, and daily trading volumes have roughly doubled from 2000 to 2005, and are up roughly 20 percent from 2004 to 2005 alone.

U.S. options exchanges operate in a highly competitive marketplace. Unlike the market for trading stocks, no options exchange enjoys a dominant market share, let alone anything like the market share the New York Stock Exchange commands in its listed

stocks. The markets for trading individual equity options have, for several years now, been characterized by cross-listing of products that are traded on multiple exchanges. The markets for trading futures, in contrast, are marked by monopoly products traded on single exchanges. Competition is a fact of life among the options exchanges, and we accept it as a fact of life between the options exchanges and exchanges that trade other products.

Since enactment of the Commodity Futures Modernization Act of 2000, the options exchanges have faced competition from a new product, security futures, or futures on individual stocks and on narrow-based stock indexes. Prior to 2000, Congress had prohibited trading in these instruments, in large part due to the concerns about the adequacy of regulating them strictly as futures.

The U.S. options exchanges did not object to the introduction of security futures. We are used to competition. But we did urge Congress to ensure that they are regulated in a manner that provides a level playing field for security options. So did the President's Working Group. Congress agreed that security futures contain elements of both securities and futures and provided a role for the SEC and the principles of securities regulation in the oversight of these products.

This was the right policy in 2000 and is the right policy today. It has allowed a new product to develop, facilitating a market participant's ability to engage in hedging and other strategies. At the same time, it has prevented regulatory arbitrage. And the way you conducted your hearings in 2000 eliminated the need for legislative arbitrage, protected investors, reduced risk in the financial markets as a whole.

The U.S. options exchanges urge Congress to maintain the parity of treatment for security options and security futures that was enacted in the CFMA. Any legislation should preserve parity, not just on day one, but going forward as well. It should not authorize any one exchange or regulator to end this parity in the future.

The U.S. futures exchanges advocate ending that parity in the crucial area of customer margin. They propose allowing the futures exchanges total discretion to set margin requirements for security futures. This approach is contained in the bill reported by the Senate Agriculture Committee. Should this bill become law, it would put Congress in the position of picking winners and losers in the marketplace, exactly what Congress sought to avoid in 2000.

The U.S. options exchanges have an alternative approach that would preserve the consistent treatment endorsed by Congress while ensuring appropriate margin levels for both products. Under this approach, Congress would direct the SEC and CFTC to adopt joint rules permitting the use of portfolio margin for securities futures and also to direct the SEC to adopt a consistent rule for securities options. I think as a consequence of today's hearing, that position was endorsed today by the SEC.

This would allow for more efficient margin treatment than the current approach used for the two products, while maintaining an adequate protection against risk. We have shared this approach with the SEC, the CFTC, and look forward to its consideration by the President's Working Group as the process of reauthorization moves forward.

I also would like to commend you, Mr. Chairman, and this Committee, for including the President's Working Group in this very key and important dialogue on this product, and I think it is important that they be part of the process.

I will conclude by noting that the SEC recently authorized portfolio margining for a narrow range of products and a narrow category of market participants. Even this relatively modest step followed 3 years of consideration by the SEC following submission of a formal proposal.

While I appreciate the need for careful review by the SEC of exchange rulemaking, that process must not move so slowly as to stifle innovation. I have said this to you before in another context. The 9-month period specified for rulemaking in our proposal is sufficient to ensure the legitimate regulatory concerns are addressed, while allowing the exchanges to move forward. The SEC testified on the first panel that the agency will move forward on this issue, and I believe they will.

Thank you again, Mr. Chairman. I would be happy to answer questions.

Chairman SHELBY. Mr. Lackritz.

**STATEMENT OF MARK LACKRITZ  
PRESIDENT, SECURITIES INDUSTRY ASSOCIATION**

Mr. LACKRITZ. Thank you, Mr. Chairman and Senator Crapo. I appreciate the opportunity to testify today on S. 1566 and to articulate SIA's concerns about a couple provisions in this bill. I would also like to thank you, Mr. Chairman, for convening this hearing and for taking the interest in these particular provisions that are of significant importance to the securities industry and to the capital markets.

We strongly support reauthorization of the CFTC this year, but we do not support certain provisions that go beyond the CFTC reauthorization and would amend the Commodity Exchange Act and the recently enacted modifications to the CEA codified in the CFMA in 2000.

We are deeply concerned with two principal areas in S. 1566: First, the provisions addressing portfolio margining; and, second, the scope of the language addressing the so-called *Zelener* decision and related foreign exchange issues, including the provisions to limit the scope of permissible activities of broker-dealers.

We support the agency rulemakings and the SRO rule approvals under the CEA and the Securities Exchange Act of 1934 that would promote the adoption of portfolio margining. Any portfolio margining legislation, however, should ensure that all financial instruments—and here we are not talking about just futures or single stock futures or options, but all financial products—should be included in a manner so it does not result in margin-based competitive disparities.

The conventional approach to margin setting is called strategy-based, and its primary deficiency is that only certain precisely specified positions are treated as offsets. Combinations of financial instruments that act as hedges to reduce risk are just not recognized unless they appear on the list of acceptable offsets. But it is simply impossible for a strategy-based system to accurately capture

all the different possible combinations of financial instruments that might change the risk of a given portfolio. That could only be done through a model to perform the necessary number crunching. So strategy-based margining creates two significant problems: First, it penalizes customers for failing to link their margin requirements to the true risk of loss in their portfolios; and, second, U.S. financial firms can and, unfortunately do lose business where customers are able to invest with financial services firms, often offshore, that are permitted to calculate margin on a portfolio basis.

An ad hoc committee of the SIA has been working with the SRO's and the SEC to expand the use of portfolio margining, really across the board, and we hope a proposal we recently submitted to the New York Stock Exchange will be approved in the near future.

We, therefore, oppose the provisions that are in S. 1566 currently. They are addressed solely to portfolio margining for security futures. These provisions are way too narrowly drawn, creating the potential for inappropriate competitive disparities across competing product markets. We would support legislation, however, that the SEC and CFTC agree would facilitate adoption of SRO rules implementing portfolio margining.

With respect to broker-dealer affiliates, we strongly oppose the provisions of S. 1566 that would cut back significantly existing provisions of the CFMA that permit SEC-registered broker-dealers and their material affiliates to conduct over-the-counter foreign exchange futures activities with counterparties that do not qualify as eligible contract participants. It is our understanding that these provisions are intended to deal with a practice in which firms establish and register shell FCM's for the purpose of permitting under-capitalized and unregulated affiliates, also known as bucket shops, to engage in retail over-the-counter foreign exchange futures activities.

We emphasize that affiliates of SEC-registered broker-dealers where most U.S. broker-dealer holding company groups conduct their over-the-counter foreign exchange activities are well-capitalized and regulated. Moreover, there is no history of foreign exchange-related abuse occurring in the context of SEC-registered broker-dealers, their affiliated entities, or the affiliated broker-dealer's personnel. Nor is there any reason to believe or suspect that such a problem will arise in the future. Requiring reorganization of this business line and registration of personnel would be both costly, burdensome, and entirely unjustified by the record.

With respect to retail foreign exchange fraud, Mr. Chairman, we understand that retail fraud in connection with speculative foreign exchange activities continues to be problematic, but we do not agree that there is a compelling need for modifications to the CEA to address these problems. We believe that the *Zelener* decision was correctly decided based on the facts that were in evidence, and we do not agree with claims that the *Zelener* decision will lead to a chamber of horrors or similar decisions in cases involving retail transactions in physical commodities that typically require costly, complex, and burdensome delivery mechanisms. We strongly support efforts to root out fraud against retail investors, but we believe the provisions of S. 1566 are overly broad and could well result in unintended adverse consequences. We are encouraged by the agree-

ment in principle by the President's Working Group and look forward to seeing that specific language.

Finally, we would add that CFMA resolved many significant issues in an innovative fashion and has enabled the U.S. derivatives market to provide important benefits for the U.S. economy. The products subject to the CEA, as well as those covered by the exclusions from the CEA are complex and extremely difficult to define. History has shown repeatedly that a lack of clarity under the CEA can produce significant adverse consequences. As such, we urge you to proceed cautiously in considering provisions that go beyond the CFTC reauthorization. We are eager to continue working with you, Mr. Chairman, your Committee, and staff to achieve your legislative objectives in a constructive manner that preserves the many benefits of the CFMA.

Thank you very much.

Chairman SHELBY. Mr. Pickel.

**STATEMENT OF ROBERT G. PICKEL  
EXECUTIVE DIRECTOR AND CHIEF EXECUTIVE OFFICER,  
INTERNATIONAL SWAPS AND DERIVATIVES ASSN., INC.**

Mr. PICKEL. Mr. Chairman and Senator Crapo, I am the Executive Director and Chief Executive Officer of the International Swaps and Derivatives Association. I appreciate the Committee's invitation to appear today to present ISDA's views on proposed legislation to reauthorize the Commodity Futures Trading Commission.

ISDA is an international organization, and its more than 650 members in 48 countries include the world's leading dealers in and many users of OTC derivatives. We welcome this Committee's interest in the CFTC reauthorization legislation.

Throughout this reauthorization process, we have worked closely with three other financial services trade associations. Two of these—the SIA and the FIA—are on our panel this morning. The third—the Bond Market Association—has filed a written statement for the record and joins in my statement today.

For the reasons explained in our written statement, our experience since 2000 confirms that Congress achieved its objectives of providing legal certainty and regulatory clarity for OTC derivatives transactions in a manner that has reduced systemic risk and encouraged financial innovation. The carefully crafted exclusions and exemptions in Section 2 of the CFMA are critical to that legal certainty.

From all indications, the CFMA has been a broad-based success for the capital markets generally. ISDA commends the CFTC for the effective manner in which it has implemented the CFMA, and we will continue to actively support passage of the legislation to reauthorize the CFTC.

As discussed in detail in our written statement, ISDA believes there is no compelling need to make substantive changes to those portions of the CFMA governing OTC derivatives. In considering any amendments, we urge the Committee to take a cautious approach. If any such amendments are agreed to, they should be narrowly targeted to specific policy problems requiring a legislative response and carefully crafted to avoid unintended collateral con-

sequences that could undermine the legal certainty provided for OTC derivatives by the CFMA.

Let me illustrate our concerns by references to proposals to amend the so-called "Treasury Amendment," which is the core provision of the CFMA intended to provide legal certainty for OTC derivatives based on foreign currency. All of these amendments seek to address the decision in *Zelener*. In that case, the U.S. Court of Appeals for the Seventh Circuit held that the foreign exchange contracts before it were not futures contracts and that the CEA's anti-fraud rules were, therefore, not applicable. The proposed amendments, including that approved by the Agriculture Committee, seek to address the *Zelener* issue by giving the CFTC for the first time jurisdiction over certain off-exchange contracts that are neither futures nor options. In ISDA's view, the *Zelener* case was correctly decided based on the facts before the court. It does not preclude the CFTC from successfully bringing similar cases in the future, and we heard this morning that the CFTC continues to pursue those cases. And it does not provide a road map for an end run around the CEA that can be exported to physical commodities such as heating oil and grain.

ISDA does not believe that it has been demonstrated that legislation is necessary to address the so-called "*Zelener* problem." Moreover, there is a significant problem that amendments will be so broad they will have collateral consequences that will undermine the legal certainty provided by Congress in 2000. Finally, Congress needs to carefully consider extension of the CFTC's jurisdiction to new classes of contracts and how that could hamper the Commission's ability to carry out its core mission of supervising the Nation's futures exchanges.

We stand ready to work with the relevant committees of Congress, including this Committee, and the members of the President's Working Group as legislative proposals are developed and considered. We believe, however, that there should be a significant burden placed on those who seek to amend what all agree is a highly effective and successful piece of legislation—the CFMA.

I thank you for this opportunity to present our views, and I am prepared to answer any questions you may have.

Chairman SHELBY. Mr. Roth.

**STATEMENT OF DANIEL J. ROTH  
PRESIDENT AND CHIEF EXECUTIVE OFFICER,  
NATIONAL FUTURES ASSOCIATION**

Mr. ROTH. Thank you, Senator. My name is Dan Roth, and I am the President of the National Futures Association. NFA is the industry-wide self-regulatory body for the futures industry. Our only mission really is customer protection, and I appreciate the opportunity to appear here today to talk about an issue that is directly related to customer protection, and that is the *Zelener* issue. If possible, I would like to take a few minutes and discuss the *Zelener* issue from a little bit of a historical perspective.

When NFA began operations back in 1982, the futures industry, frankly, was plagued with a pretty large-scale sales practice problem. There were a lot of boiler rooms. They were very big, and they were very brazen in their fraud.

Since 1982, when we began operations, volume on U.S. futures exchanges has grown by well over 1,200 percent. During that same period of time, customer complaints have actually dropped by over 75 percent, and that dramatic drop was not an accident. It was the result of a lot of hard work and a very close working relationship between the CFTC and NFA to crack down on those boiler rooms.

Unlike Mr. Pickel, I am concerned that the impact of the *Zelener* decision could be to return us to the bad old days of the wild, wild West because I do think it provides something of a road map to the fraudsters on how to avoid CFTC jurisdiction. And let me see if I can explain that.

Prior to *Zelener*, the main case dealing with the definition of "futures contracts" for retail customers was the *Co Petro* decision, which was decided in 1982, and there the court rejected the idea of any bright-line test or definition for "futures contract," but they said we have to look at the underlying purpose of the transaction, and they found that where the contract for future delivery is being marketed to retail customers as a speculative investment vehicle and those retail customers have no expectation of delivery, then that was a futures contract subject to the CFTC's jurisdiction.

In *Zelener*, you basically had all of those elements present, but the court there found that the contracts were not futures contracts because, instead of focusing on the underlying purpose of the transaction, they focused primarily on the written contract between the parties. And because there was no guaranteed right of offset, the court found that they were not futures.

Now, I understand that the President's Working Group agrees that Congress should do something to address the *Zelener* issue, and that is good. I understand that their proposal will be limited in scope to the forex area, and I am sure that their reasoning is that the forex is where the problem is so that is where the solution should be. And that sounds pretty reasonable. But I think that reasoning ignores two important factors.

First is the language of the decision itself because there is nothing in the *Zelener* decision which limits its application to forex products. If a fraudster can set up a *Zelener*-type contract for forex and avoid the CFTC's jurisdiction, he can do the same thing with a *Zelener* contract for heating oil.

Second, I think the narrow approach ignores the history of sales practice problems in the futures industry because the fact is that in our 20 years of experience, frankly, what boiler rooms love to sell are products that retail customers have day-to-day experience with. So that for years, I mean, the problems tended to be sugar futures, and then it was orange juice, and then it was metals, and then it was unleaded gas, and then it was heating oil. But it was always something that the customers could relate to based on their day-to-day experience, and, frankly, forex does not fit that mold at all. Forex became the scam of choice only when it became recognized as an unregulated niche. And that really happened in a 1996 decision called *Frankwell Bullion* where the court found that CFTC had no jurisdiction over retail forex transactions. That is when forex became the unregulated niche. That is when the fraudsters started selling forex, and that is when our problems began to mushroom. Congress tried to address that in the CFMA,

but I think their efforts were largely negated by the *Zelener* decision.

I think the problem I have with the so-called “narrow fix” is that I do not think it is a fix at all. It does not really close the unregulated niche. It just shifts it. It seems to tell the fraudsters that they cannot sell *Zelener* contracts for forex, but it could suggest that they can sell those types of contracts for heating oil, unleaded gas, or any other product and do so outside the regulatory jurisdiction of the CFTC. That is basically an invitation to the fraudsters, and if some people feel that they will not take up that invitation, well, I respectfully disagree.

The better approach, I think, is not to expand the CFTC’s jurisdiction, which is, frankly, what I think the Senate Ag Committee bill did. I do not think the right solution is to do anything new. I think the right solution is to do something old and tried and true and tested, and that is to codify the *Co Petro* decision, and that is what our proposal, which is attached to my testimony, would basically do.

I see the red light is on, so let me wrap up by just saying that I believe that our proposal would not in any way impose a rigid definition of futures contract. It would not disturb jurisdictional boundaries between agencies. It would not implicate any forward contracts or spot contracts. It would not interfere with otherwise regulated entities and their ability to sell retail forex. It would simply codify the *Co Petro* decision, which stood for over 22 years and which gave the Commission ample authority to protect retail customers without inhibiting legitimate business activity.

I know there is a fair number of people that disagree with me, Senator, and you heard from a lot of them today. And I kind of expect I will be getting fewer Christmas cards this year. But the fact is that—

Chairman SHELBY. You will have fewer to open, won’t you?

[Laughter.]

Mr. ROTH. The fact is that codifying the *Co Petro* decision I think is the right response to the *Zelener* issue, and if Congress does, in fact, adopt the narrow approach, I would at least hope that there would be a firm commitment that we would not have to wait 5 years until the next reauthorization process to address this issue, to revisit this issue and to get it right, because I would hope that when the problems are discussed become more apparent, then we could revisit the issue—if, in fact, Congress takes the narrow approach, which I hope they will not.

Thank you, Senator. I would be happy to answer any questions.

Chairman SHELBY. Thank you.

During the first panel of witnesses—most of you were here, I believe—they discussed whether the current regulatory regime fits the realities of the marketplace where futures and other financial products are virtually indistinguishable and are traded by affiliates of the same broker-dealers. I would like each of you briefly to address whether the current regulatory regime should be modernized to reflect market realities. Does the jurisdictional line between the SEC and the CFTC still make sense? This is central to all of this. Mr. Carey, just briefly.

Mr. CAREY. In light of the—

Chairman SHELBY. Yes or no.

Mr. CAREY. Yes or no? I guess——

Chairman SHELBY. Well, and a few more words.

[Laughter.]

Mr. CAREY. Well, I think while we are here to express frustration on certain parts of CFMA, the fact of the matter is I would be hard pressed to argue for a different regulatory scheme after the growth that we have witnessed over the last 5 years since its passage. So I would have a hard time supporting a wholesale change to the regulatory framework.

Chairman SHELBY. Mr. Damgard.

Mr. DAMGARD. I would agree with Mr. Carey. I think our markets globally have probably tripled in the last 3 years, and I think from the standpoint of modernization, thanks to this Committee and the Ag Committee, we did a lot of that work for you 5 years ago.

I do think there is a difference. I mean, futures markets have historically been institutional markets, and the mission of the CFTC has been to protect the market. The regulatory regime has worked very well. And I think that there is a lot of credit to be spread around on the basis of the success of these two exchanges and other exchanges around the world.

The SEC obviously has a different role; its regulatory regime is centered on customer protection rather than market protection. And those two missions are at least different enough so that I think the current regulatory scheme serves at least our market pretty well. We have seen other countries that have combined their regulators, particularly in Great Britain. It is awfully difficult to pass rules that are going to work across the board. One shoe really does not fit all.

Chairman SHELBY. Mr. Duffy.

Mr. DUFFY. I actually think that Mr. Damgard and Mr. Carey said it all. I definitely agree with their comments. I do not believe that these agencies at this time should even be remotely considered for being put together. I think that our industry has been able to prosper and grow. I think Mr. Roth cited some incredible growth numbers over the last several year.

Chairman SHELBY. Is the market ahead of the regulatory regime?

Mr. DUFFY. Is the market ahead of the regulatory regime?

Chairman SHELBY. Yes.

Mr. DUFFY. No.

Chairman SHELBY. You do not think so?

Mr. DUFFY. No.

Chairman SHELBY. Mr. Frucher.

Mr. FRUCHER. What an extraordinarily prescient question. I think it goes right to this question of regulatory arbitrage. What you see here is the futures industry trying to move into, legitimately, in a competitive way, a realm that had traditionally been on the securities side of the business.

Chairman SHELBY. Eighty percent, more or less, of the futures financial products perhaps?

Mr. FRUCHER. That is correct. And I think your point is certainly an open question that requires a look-see. We talk about the need

for modernization here or change in the margin requirements because, "this product," which is really a securities-related product, is not competitive. But the fact is this product has not been successful and it really has not been successful in Europe. It has been successful in parts of Europe—Spain, for example—and it has been successful in India where the securities markets are not particularly efficient. And what you have now is a world that is moving away from floor-based exchanges into electronic markets. Those electronic markets are going to be traded on one screen—equities, options, and equity futures. And you are going to trade Microsoft three different ways. And if you are going to have regulatory arbitrage between these products, I think you are opening up a serious Pandora's box. Who knows? These people may be trading Pandora's box futures in the future, because I think that this question that you have before you today opens up this question.

Chairman SHELBY. Mr. Lackritz.

Mr. LACKRITZ. Mr. Chairman, I would echo a lot of what Mr. Frucher has just said. I think we have a historical anomaly here where we have a futures market that began as an agricultural futures market evolving into basically a financial futures market that is inextricably linked with other financial markets. And I think there is no question about the fact that the technology is driving the products and the services into convergence. So, I think it clearly deserves a very careful look.

I would suggest as well that as you look at other jurisdictions around the world, they do organize this differently in terms of their regulatory oversight. And some have been more successful, some have been less successful. But at the same time, this clearly deserves a careful look. It is a complicated area, and it is one of those areas that can absorb huge amounts of time and energy of the Committee. But at the same time, it is very important and I think very appropriate to take that look.

Chairman SHELBY. Mr. Pickel.

Mr. PICKEL. I think what we have focused on is the underlying risk and how it gets managed. We have developed, working with our membership—

Chairman SHELBY. That is central, is it not, the underlying risk?

Mr. PICKEL. That is right. We have developed an extensive documentation structure, market practices, private discipline in the derivatives business, the OTC derivatives business, that has served the market extremely well. And so it manages the risks that you might manage in the cash markets or on the futures exchanges, but it does it through this private discipline that has been developed, and we think that is a very important feature of that particular product.

Chairman SHELBY. Mr. Roth.

Mr. ROTH. Senator, the only point I would make would be that it is an interesting question to consider, but in considering it, one should never underestimate the value of having a regulatory agency which is devoted to futures, which has deep expertise in understanding these markets and can be responsive to its regulatory challenges.

Chairman SHELBY. But the regulatory regime has to understand the very complicated products as they evolve, doesn't it?

Mr. ROTH. That is exactly right, and I think that there is a real value to having that expertise reside in one agency that focuses on futures products, and it has been a tremendous benefit to the futures industry over the past—well, since the CFTC was created in 1974.

Chairman SHELBY. The representatives of the President's Working Group that you heard recommended basically that Congress respond to the *Zelener* decision by adopting a narrow amendment that addresses only retail foreign exchange products. What about this? What is the merit of this recommendation? In your view.

Mr. Carey.

Mr. CAREY. Well, Mr. Chairman, I think that they want to keep it specific to forex only, but our concerns are that it will spread to other commodities, as was stated so well by Chairman Terry Duffy of the Mercantile Exchange, and Dan Roth. So these are our concerns. What is the merit of a forex fix? We think we will be back for other fixes afterwards.

Chairman SHELBY. Mr. Duffy, do you have a different view?

Mr. DUFFY. No, obviously not. We agree with the President's Working Group, what they believe should be done, except that the fix does need to extend to other commodities because we really cannot draw that line like they can for some reason. We can see, like Mr. Roth clearly can see, that scamsters are certainly going to go to the product de jour.

Chairman SHELBY. Any of you have a different opinion?

Mr. Damgard.

Mr. DAMGARD. I think the issue here is really the resources of the agency. If Congress wants to create another consumer fraud agency, they really should reflect on what kind of resources are necessary. The CFTC has done an excellent job over the last 25 or 30 years nurturing the growth of futures markets.

Chairman SHELBY. That has primarily been financial futures products, hasn't it?

Mr. DAMGARD. That has grown a lot, but there are also energy markets and agricultural markets. I mean, the mechanism itself has proved to work across the board on financial instruments just as easily, as Mark pointed out, originally agricultural products.

Chairman SHELBY. Mr. Roth.

Mr. ROTH. With respect to the CFTC's resources, I would just point out that the day before the *Zelener* decision, the CFTC had precisely the authority that we are trying to restore, and their resources were just fine. In fact, the track record that I cited in the decline of customer complaints is largely a result of their enforcement efforts. So we are not talking about an expansion of CFTC responsibility. We are talking about restoring its responsibility. It had the resources necessary to do the job very well the day before the *Zelener* decision, and I think it would have the same resources and the same ability today.

Chairman SHELBY. Mr. Lackritz.

Mr. LACKRITZ. Mr. Chairman, with all due respect to my colleagues on the panel, I think that the *Zelener* case does not need to give rise to any new legislative fix. I mean, we used to have a saying in law school about bad cases making bad law, and this particular case I think was decided exactly right based on the facts

that were presented by the litigants. The Solicitor General of the United States decided not to take it up further. So from that standpoint, I think the case on its facts before the court was rightly decided.

In addition, the case is now over a year old, and we have no evidence whatsoever that there is a broad problem that has resulted as a result of this particular case. So, I do not think there is any need for it.

Chairman SHELBY. Mr. Pickel.

Mr. PICKEL. We have advocated the President's Working Group getting engaged on this and certainly will take a serious look at the proposals that they have developed, but I would share Mr. Lackritz's view. The court case basically said that they did not have other facts presented to them so that their only solution was to look at the written contract. I am sure that the CFTC in the cases that it is developing now and bringing in a similar fashion is developing that factual record so that if they truly believe that those are futures contracts, a court in another circuit will find them to be futures contracts.

Also, the *Zelener* case did not overrule *Co Petro* as the test for what a futures contract is. It just interpreted based on the facts before it whether the elements of a futures contract applied in that case.

Mr. ROTH. Senator?

Chairman SHELBY. Go ahead.

Mr. ROTH. Just that with respect to Mr. Pickel's comments, the *Zelener* decision did not explicitly overturn the *Co Petro* decision, but it basically tore its guts out. It did so by saying that we are not going to look at the underlying purpose of the transaction, we are going to look at the written agreement and look and determine whether there is a guaranteed right of offset. The notion that the CFTC—God bless the CFTC if they can litigate their way out of this thing—but I think it is putting an awful lot of chips on a bet that is no sure thing, because the idea that they will be able to present testimony or evidence of oral representations made by a salesman concerning a guaranteed right of offset suggests that the salesman cannot be more evasive than the written contract. And I have dealt with these salesmen long enough to know that that is just not true.

So, I think the idea of litigating our way out of this problem is a pretty difficult and tall order.

Mr. FRUCHER. Mr. Chairman, I think your first question, interestingly enough, has some relevance here. I think the question may not be a single legislative fix on the *Zelener* situation but, rather, to look at the gaps between regulators. I think that is a bigger issue, and that is the one I think that really deserves to be looked at. There are gaps.

Chairman SHELBY. I am going to defer to my Harvard Law graduate, Senator CRAPO, right now and see what he says about all this. [Laughter.]

Senator CRAPO. Mr. Chairman, frankly, the discussion that you just caused to happen here answered most of the questions that I was going to ask. But one question that I do want to get into which takes the current discussion another step further is, as I listen to

this panel, I can see that Mr. Carey, Mr. Duffy, and Mr. Roth would like to have a broader solution for the *Zelener* case. And I am assuming that the others would support the more narrow solution. Is that correct?

Mr. DAMGARD. That is correct.

Senator CRAPO. I think that the question is, as Mr. Roth proposes, that we just go back to the *Co Petro* case. I think we probably all felt that that was the standard before the *Zelener* case was decided, and there is a little dispute among the panel members here as to whether the *Zelener* case is really going to be a broad case or not and create a big loophole or not. But this notion of a broader legislative solution to the *Zelener* case I think raises a question as to whether Congress will, intentionally or not, change that jurisdictional balance that the CFMA created. I think that is the real issue here that is behind the positions that people are taking.

And so first I wanted to ask, if I am correct about that, if you believe that there is a risk here, that if Congress starts going down the road of trying to figure out a broader solution than the one that the President's Working Group apparently is going to put forward, will that create an imbalance—or will that change the balance of jurisdiction that we now have that seems to be working so well as a result of the President's Working Group conclusions and Congress' actions in 1999 and 2000?

Mr. DAMGARD. I think that is the danger, Senator. We think the problem is FX only. What we have proposed I think is a scalpel approach to the problem of fraud versus the sledge hammer approach. Firms have gotten into the business of doing legitimate FX business. Customers now have a choice between taking their business to an exchange or doing this business with a legitimate counterparty. The problem has been in the shell FCM's go in and register without any qualifications at all and create an affiliate. We are proposing that we require \$20 million capital to be an FCM and have the affiliate that is actually selling the product register with the CFTC. That gets at the FX problem.

Congress did carve out a special role for the CFTC in the 2000 CFMA for FX based on the Treasury Amendment, and that is why we have looked at this and decided that, from the CFTC's standpoint, this grants them all the authority that they really need.

Senator CRAPO. Mr. Duffy.

Mr. DUFFY. Senator, right now I believe that the CME's and the NFA's approaches obviously are very similar, and we do not believe that this affects any legitimate business dealings. For anybody that has legitimate, bona fide business in any product, our solution does not impede them from doing business, and for us to go back to things pre-*Zelener* we think only makes sense.

To think that we can fix it in FX and leave it alone in other products I think is a little bit naïve. In light of what is going on in this world, I actually believe exactly what Dan is saying, that it is insufficient to merely stop fraudsters from conning people for FX and ill-gotten gains. It is going to be very easy for these scamsters to pick up the phone and tell somebody how they can create 80-percent gains in heating oil in the next 3 weeks in light of what is

going on. I mean, people are actually going to believe that type of sales pitch.

So we are very concerned about this, and we do believe it needs to be a broader fix, and we do not believe our fix impedes any legitimate business dealings.

Mr. ROTH. Senator, you are exactly right on what the problem is here. I am sick of talking about *Zelener*. I have been talking about it with everybody for a real long time, and I have not talked to anybody that disagreed with me that was in favor of fraud. No one, none of the people that disagree with us are on that point. The trick is trying to restore the CFTC's jurisdiction in a way that does not disturb any of the jurisdictional agreements that were part of the CFMA. And it is not easy, and we have worked very hard to try to craft our proposal in a way that does precisely that. We are not aware of any way in which we would be infringing on another agency's jurisdiction, not aware of any way in which we would be infringing on legitimate business activities. But for God's sake, if there is something in our proposal that does that, let us know and we will find the right words in the English language to do it. But we should not have to settle for a narrow fix that I think it just shifts the unregulated niche and does not really address the underlying problem.

Mr. LACKRITZ. Senator Crapo, if I can just address that question you raise, I think your concern is exactly right in terms of the risk of any kind of broad-based solution, or even a narrow-based solution here, which is to alter the balance that has worked so effectively as a result of the CFMA in 2000. I am pushed back to the old adage that physicians take the Hippocratic Oath, which is, "First, do no harm." And given the fact that this is one decision in one case where the facts were not presented very well in the record, to justify adding all of this other legislation and new law and new authority is a very slim reed to base that one.

Mr. PICKEL. I think the balance that was struck in the CFMA is exactly why the President's Working Group is looking at a narrow fix and the FIA has proposed a narrow fix, because there was a determination in the CFMA that as it relates to retail foreign exchange futures, there would be authority for the CFTC to take action. So, I think it is appropriate in that context if Congress wants to look at the *Zelener* case and whether it undermined that policy decision. But what we are hearing from some of the panelists is a broader opening up of that policy decision from 2000, and it does run the risk of upsetting some of the balance that you allude to.

Senator CRAPO. Anybody else want to jump in?

Mr. FRUCHER. There is only me, and I agree with that side.

[Laughter.]

Senator CRAPO. I figured that.

All right. I know that our time is basically gone, and I appreciate, again, Mr. Chairman, you letting us do this, and I look forward to exploring a lot of this further as we conduct our hearing in the Subcommittee.

Chairman SHELBY. Thank you, Senator Crapo.

Senator CRAPO. Thank you.

Chairman SHELBY. I want to thank all of you for appearing. We have had a spirited discussion. We think these are very important issues that we are dealing with and very complicated issues.

Thank you very much.

[Whereupon, at 12:13 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

### PREPARED STATEMENT OF SENATOR MEL MARTINEZ

I would like to thank Chairman Shelby and Senator Sarbanes for holding this hearing and for their efforts to work in cooperation with the Senate Agriculture Committee on the Commodities Exchange Act Reauthorization legislation.

Five years ago, when Congress reauthorized the CEA, the Banking and Agriculture Committees worked cooperatively with the input of the President's Working Group and industry representatives to develop changes to the Commodities Exchange Act that revolutionized over-the-counter derivatives and security futures products. By providing a regulatory regime that recognized that certain financial products have attributes of securities and futures and giving the SEC and the CFTC shared regulatory authority, the Commodity Futures Modernization Act created parity among single-stock futures and options. Industry and the President's Working Group agreed that the legislation that was passed 5 years ago has been very successful. However, the markets are very sophisticated and can change overnight. There have been numerous market developments, specifically changes in the traditional futures market, since Congress last reauthorized the CEA that this Committee needs to study and have input on before a final CEA reauthorization bill can go to the floor of the Senate.

Our witnesses today are going to speak on several major issues that must be addressed and fully vetted by this Committee. These issues include portfolio margining, the definition of narrow-based securities, the jurisdiction the CFTC has over retail foreign exchange contracts, and broker-dealer registration requirements.

Before the Senate can reauthorize the CEA for the next 5 years, the Agriculture and Banking Committees need to work together as they did 5 years ago to ensure that all of these issues have been fully explored and that parity in the markets is maintained.

Thank you to our witnesses. I look forward to their testimonies.

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### PREPARED STATEMENT OF RANDY K. QUARLES

UNDER SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

SEPTEMBER 8, 2005

Thank you Chairman Shelby, Ranking Member Sarbanes, and other Members of the Committee. I appreciate the opportunity to address certain issues that have arisen in the context of Congressional reauthorization of the Commodity Futures Trading Commission (CFTC). As you know, Treasury is a Member of the President's Working Group on Financial Markets and the Secretary serves as the PWG's Chairman. The other Members of the PWG are the Chairmen of the Federal Reserve Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission.

In recent weeks, the PWG Members and senior staff have met to discuss the effect of last year's 7th Circuit Court of Appeals decision in *CFTC v. Zelener* on the CFTC's antifraud authority, in particular the CFTC's ability to address retail foreign exchange fraud by otherwise unregulated entities. The proposal that we have produced reflects a consensus of the President's Working Group that would make narrow changes to the CFTC's antifraud authority to provide the CFTC with enforcement tools to combat fraud against retail customers involving certain foreign exchange contracts, while preserving the complex and delicate compromises reached in the Commodity Futures Modernization Act of 2000 (CFMA). In this regard, the President's Working Group opposes extension of such provisions beyond retail foreign exchange contracts to other commodities.

#### **The Importance of the Commodity Futures Modernization Act of 2000**

The CFMA provided important legal certainty to risk management efforts. Businesses, financial institutions, and investors throughout the economy rely on derivatives products to protect them from market volatility and unexpected events. The ability to manage risks makes the economy more resilient to financial and economic events and imbalances, and its importance cannot be underestimated. Consequently, the President's Working Group believes that major changes to the significant modernizations made by the CFMA are not warranted.

The CFMA modified the Commodity Exchange Act (CEA) so that provisions of the Act (including antifraud provisions) apply to foreign exchange futures and certain options with retail customers if the counterparty is not an otherwise-regulated entity such as a financial institution, broker-dealer, Futures Commission Merchant (FCM), or insurance company. Those changes were intended to provide the CFTC

with tools to pursue fraud against retail customers by bucket shops offering certain foreign exchange contracts. In the 2004 *Zelener* case, the CFTC's jurisdiction over a retail foreign exchange contract was challenged, and the 7th Circuit found that the CFTC lacked jurisdiction over the specific contract in question. The President's Working Group is supportive of narrow and tailored changes to the CEA that would address the *Zelener* issue.

#### **Pursuing Retail Foreign Exchange Fraud**

The changes we are proposing would be limited to cover only certain retail foreign exchange contracts that have been the subject of abuse. Any such changes must be very carefully formulated to avoid creating barriers or undue burdens for legitimate businesses, undermining legal certainty, and creating unintended consequences. As a consequence, the President's Working Group opposes the extension of such provisions for retail foreign exchange contracts to other commodities, absent a clearly demonstrated need and thorough public policy debate.

#### **President's Working Group Consensus on Pursuing Retail Foreign Exchange Fraud**

At the direction of the President's Working Group, senior staff of PWG member agencies have been meeting frequently to discuss and draft a legislative proposal to address fraud perpetrated against retail customers using futures or futures-like foreign exchange contracts. The staff group has drafted language that would accomplish that goal in two ways: (1) by applying the CEA or its antifraud provisions to certain retail foreign currency futures and certain options, and their sales chains, when an FCM is involved; and (2) by applying the antifraud provisions to certain retail foreign exchange contracts that are not securities, contracts that result in actual delivery within 2 days, or certain contracts in connection with a line of business, as well as to their sales chains.

The PWG proposal makes futures transactions and certain options in foreign currency between a retail participant and a counterparty that is not an otherwise-regulated entity—such as a financial institution, broker-dealer, or insurance company—subject to the CEA. It also would provide the CFTC with antifraud jurisdiction over such retail foreign exchange contracts, and the persons who engage in activity in connection with those contracts, if the counterparty is an FCM. Any person who participated in the solicitation or recommendation of any such contract within the FCM sales chain would have to register with the CFTC and be a member of a registered futures association, in this case the National Futures Association (NFA), the futures industry's sole self-regulatory organization. The PWG proposal would preserve the exclusion for otherwise-regulated entities crafted by the CFMA.

#### **Retail Foreign Exchange Futures-Like Contracts**

The PWG proposal would make certain foreign currency contracts between a retail participant and a counterparty that is not an otherwise-regulated entity subject to CFTC antifraud jurisdiction if the contracts were leveraged, margined, or financed, except that they would not apply to securities, contracts that result in actual delivery within 2 days, or certain contracts in connection with a line of business. It also would make such retail foreign exchange contracts and the persons who engage in activity in connection with those contracts subject to the antifraud provisions of the CEA. Additionally, any person who participated in the solicitation or recommendation of any such contract would have to register with the CFTC and be a member of the NFA. Again, this proposal would preserve the previous carefully crafted CFMA exclusion for otherwise-regulated entities.

#### **Portfolio-Style Margining Systems**

The CFMA granted to the Board of Governors of the Federal Reserve System (Board) the authority to establish margin requirements for security futures products. The Board delegated that authority to the SEC and CFTC jointly. The SEC and CFTC continue to work toward permitting portfolio-style margining models. The Treasury Department generally supports the concept of portfolio-style margining systems, which increase the efficiency of capital allocation and encourage risk management activities. We note that some progress has been made very recently and we remain hopeful that the SEC and CFTC can work together to facilitate the implementation of such margining systems soon.

#### **Securities Futures Products and Narrow-Based Indexes**

The CFMA created a distinction between broad-based security indexes, which have been regulated solely by the CFTC, and narrow-based security indexes, which are regulated by the SEC and CFTC jointly. The definition of "narrow-based security index" seems to have been formulated using criteria appropriate for equity secu-

rities, as opposed to debt securities. The Treasury Department generally supports reviewing the appropriateness of certain criteria in the definition of “narrow-based security index” in the context of debt and foreign security index futures given that the nature of the underlying securities differs from domestic equities.

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**PREPARED STATEMENT OF ROBERT L.D. COLBY**  
 DEPUTY DIRECTOR OF THE DIVISION OF MARKET REGULATION  
 U.S. SECURITIES AND EXCHANGE COMMISSION  
 SEPTEMBER 8, 2005

**Introduction**

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I am pleased to appear today to testify on behalf of the Securities and Exchange Commission (Commission) to express the Commission’s views on the Commodity Exchange Reauthorization Act of 2005, S. 1566, reported out of the Senate Agriculture Committee on July 29, 2005. My testimony will focus on those sections of S. 1566 that would affect the regulatory framework for security futures products established by the Commodity Futures Modernization Act of 2000 (CFMA), which is administered jointly by the CFTC and the SEC.

The Commission shares the concerns of this Committee’s Chairman and Ranking Member expressed in their letter of July 20 to the Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry regarding Section 7 of S. 1566. The Commission supports the expansion of portfolio margining to all equity products but believes it should be accomplished without undermining the current requirements regarding comparability between security futures margin and options margin. The Commission also has serious concerns about the amendments in Section 8 of S. 1566. These changes would remove products currently considered securities from Commission oversight, thereby compromising both investor protection and market integrity and prohibiting securities exchanges from trading such instruments.

Finally, the President’s Working Group on Financial Markets (Working Group) has reached an agreement in principle on how to address the questions raised in the 7th Circuit’s decision in *CFTC v. Zelener*. Commission staff has been working diligently with staff of the other members of the Working Group and has reached agreement on how to grant the CFTC targeted, additional antifraud authority, and an appropriate registration requirement for solicitors of retail foreign exchange contracts, that they believe would address *Zelener* without compromising legal certainty or competitive parity.

On this point, the Commission would especially like to thank the CFTC and its staff for their significant contribution to this effort. We fully support the CFTC in its efforts to combat retail foreign currency fraud.

**Security Futures**

**CURRENT REGULATORY FRAMEWORK**

The Commodity Futures Modernization Act of 2000 (CFMA) was a significant legislative achievement. Among other things, it lifted the ban on the trading of futures on single stocks and narrow-based indexes and established a framework for trading security futures products over which the CFTC and the SEC share regulatory authority. Its enactment was the product of much effort by Congress, the members of the Working Group, and participants in the securities and futures industries. The SEC has a significant and legitimate interest in any legislative changes that affect the consensus achieved in the CFMA.

The ban on single stock futures was considered as part of the Working Group’s 1999 report on OTC derivatives and the Commodity Exchange Act.<sup>1</sup> The report identified several important issues to be resolved before trading of single stock futures should be permitted, including issues about the integrity of the securities market and regulatory arbitrage. In December 1999, various Members of Congress requested that the Chairmen of the SEC and CFTC formulate a legislative plan for lifting the ban on single stock futures. The legislative proposal negotiated by the Chairmen of the two agencies to eliminate the ban on single stock futures was transmitted to Congress by the Working Group in September 2000. Much of this proposal was incorporated into the bill that was enacted by Congress as the CFMA.

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<sup>1</sup> Report of the President’s Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (Nov. 1999) (OTC Derivatives Report).

Under the joint regulatory framework established by the CFMA, security futures may trade on both futures and securities exchanges, as well as derivatives transaction execution facilities and alternative trading systems. Moreover, broker-dealers and futures commission merchants are both permitted to trade these products and offer them to their customers. While both agencies have enforcement and examination authority, it is clear that the CFTC is the lead regulator for futures markets and futures commission merchants and that the SEC is the lead regulator for securities broker-dealers and securities markets. Consultation between the two agencies generally is required when examinations or enforcement actions are undertaken, and examination reports of the lead regulator are to be used whenever possible.

The SEC staff has worked cooperatively with the CFTC in overseeing the market for security futures products. For example, our coordinated efforts to fulfill the objectives of the CFMA led to the establishment of a memorandum of understanding between the SEC and CFTC under which the two agencies agreed to share examination and trading-related information, coordinate examinations involving security futures activities, and notify each other concerning significant regulatory issues in the oversight of security futures products.

The SEC shares regulatory authority over security futures products because such products are surrogates for their underlying securities and therefore can be used to engage in frontrunning and manipulation in the underlying securities markets. For example, an investor who has agreed to sell a block of stock at the closing price could buy futures on that stock with the expectation of causing the stock's price to tick up at the close. In the same fashion, single stock futures and narrow-based security index futures have the potential to be used for insider trading and inter-market trading abuses, such as frontrunning and market manipulation. Because security futures are a substitute for their underlying securities and, therefore, have the potential to impact those underlying securities markets, the CFMA applies the securities laws to these products.

In addition, unlike many OTC derivative products, which are complex and relatively inaccessible to retail investors, security futures are readily available to retail investors. An intermediary can offer an investor either a security futures product or the securities underlying that product, or both. The CFMA recognizes that direct access to audit trails, coordinated market surveillance, and inspection authority, as well as suitability and customer protection regulation, are all necessary to the SEC's ability to regulate effectively and protect investors. Finally, the CFMA clearly provided that security futures could not be used to avoid the registration and disclosure provisions of the Securities Act of 1933 (Securities Act).<sup>2</sup>

#### CHANGES TO REGULATORY FRAMEWORK FOR SECURITY FUTURES PRODUCTS IN S. 1566

The SEC believes that, if enacted, the changes to the current SEC-CFTC regulatory framework that are provided for in Sections 7 and 8 of the Commodity Exchange Reauthorization Act of 2005 would disrupt the jurisdictional balance and regulatory interaction that Congress, the members of the Working Group, and participants in the securities and futures industries have worked so hard to achieve, undermining both the accomplishments of the CFMA and our ability to protect investors and maintain market integrity. The SEC's specific concerns are discussed below.

##### *Portfolio Margining*

*Importance of Comparability of Margin Requirements.* The SEC supports the implementation of risk-based portfolio margining for all equity products. Under such a methodology, customer margin levels are determined by assessing the market risk of a "portfolio" of financial instruments taken as a whole. The advocates of this approach stress portfolio margining results in customer margin requirements that more realistically reflect the risk to the broker-dealer of financing the customer's securities positions better than the current strategy-based methodology, which computes margin requirements for each individual position or strategy in a portfolio. Of course, this result depends on the accuracy of the models used to calculate risk, under normal and extreme market circumstances. While Section 7 of S. 1566 would permit security futures margin to be calculated using a portfolio margining methodology, it would do so by removing the current requirements regarding comparability between security futures margin and exchange-traded options margin, and eliminate the SEC's role in establishing margin requirements for security futures.<sup>3</sup>

<sup>2</sup> See Section 2(a)(3) of the Securities Act, 15 U.S.C. 77b(a)(3).

<sup>3</sup> Section 7 of S. 1566 would relieve certain markets trading security futures from the requirement to comply with the rules jointly adopted by the Commission and CFTC under Section

Because of the balancing that is required to ensure equivalent margin treatment among related instruments, the SEC strongly believes that it would not be advisable for Congress to effect these changes to the joint regulatory framework for security futures through legislation. In fact, the SEC fears that these changes might lead to regulatory arbitrage between security futures and options. The amendments in Section 7 of S. 1566 would, for example, permit futures markets to establish portfolio margin requirements that treat unfavorably instruments held in a portfolio that were traded on a competing market. The SEC firmly believes that margin requirements should not be permitted to be used to gain a competitive advantage for securities futures over options.

The SEC believes that competition should be based on better products, services, and prices—not on regulatory differences. To avoid this possibility, the CFMA established that the margin requirements for security futures shall be no lower than margin requirements for comparable options contracts and that margin requirements would be set jointly by the SEC and CFTC.<sup>4</sup> These requirements were included to ensure that security futures were not provided a regulatory advantage over options and that exchanges would not compete on the basis of margin requirements. The changes in Section 7 of S. 1566 violate this principle and would provide security futures a regulatory advantage over securities options—products that are economic equivalents.

*SEC Action.* Importantly, if done imprudently, risk-based margining involves risks to the firms providing the margin, the investors, and the markets as a whole. For this reason, risk-based margining must be done carefully by the entity with the greatest familiarity with the issues involved. Therefore, other than initial margin requirements for stock, margin requirements in the securities markets are proposed, in the first instance, by the self-regulatory organizations, or SRO's. The SRO's are best able to draw on the expertise of their members in developing such proposals. The SEC believes this is a more prudent approach to implementing risk-based portfolio margining, but acknowledges that this has not been our top priority over the past few years. However, on July 14, 2005, the SEC approved companion proposals by the NYSE and the CBOE that permit their members, on a pilot basis, to compute certain customers' margin requirements using a portfolio margin methodology. These portfolio margin rules are limited to portfolios of financial instruments based on broad-based security indexes such as the S&P 500, Nasdaq 100, and the Russell 2000. Moreover, Chairman Cox has met recently with CFTC Chairman Jeffery and has committed to making the expansion of portfolio margining a priority.

In taking steps to expand portfolio margining to a broader array of financial instruments, including single stock futures, narrow-based securities index futures and other equity securities, and a wider range of customer accounts, the SEC staff has been actively discussing with the securities industry and the NYSE an approach to portfolio margining that would both lower margin requirements and protect against systemic risk in the event of extreme market movements. The SRO's have reinvested their efforts to allow for risk-based portfolio margining, and we anticipate that the NYSE and CBOE will propose to expand their portfolio margining pilot based on recommendations of a committee composed of representatives of the securities firms, the NYSE and CBOE.<sup>5</sup> Recently, this committee reached agreement on an approach to portfolio margining that allows its full benefits to be realized, while retaining the prudential benefits of margin requirements. Accordingly, we expect the SRO's to file a proposal that would expand portfolio margining to include equity products.

*Amendments to SIPA.* The SEC believes that Congress can promote portfolio margining by targeted legislative changes to the Securities Investor Protection Act of 1970 (SIPA), which will encourage customers to take full advantage of new portfolio margining rules. The NYSE and CBOE portfolio margin rules necessarily have a cross-margin component under which futures and futures options can be combined with related securities to make up a portfolio, provided the futures positions offset

7(c)(2)(B) of the Exchange Act or any SRO rules pertaining to the levels of initial and maintenance margin that would preclude the implementation of portfolio margining.

<sup>4</sup>Section 7(c)(2) of the Exchange Act directs the Board of Governors of the Federal Reserve System (Federal Reserve Board) to prescribe rules establishing initial and maintenance customer margin requirements imposed by brokers, dealers, and members of national securities exchanges for security futures products. The Federal Reserve Board may delegate this rulemaking authority jointly to the Commission and the CFTC, which it did on March 6, 2001. The Commission and the CFTC adopted customer margin requirements for security futures on July 31, 2002. See Securities Exchange Act Release No. 46292, 67 FR 53416 (August 14, 2002) (File No. S7-16-01).

<sup>5</sup>SEC, Federal Reserve Board, and CFTC staff have also been invited to participate as observers in meetings of this committee.

securities positions. For example, a portfolio made up of securities based on the S&P 500 could include futures and futures options based on the S&P 500 as well. Losses on the securities positions could be offset by gains on the futures positions to arrive at the customer's margin requirement.

Under the NYSE's and CBOE's rules, the securities and futures positions must be carried in a securities account to provide the customer with the protections of the securities laws and regulations. This raises an issue as to how the futures positions would be treated in a liquidation of the broker-dealer under the SIPA.

SIPA was enacted to protect customers of a failed broker-dealer. In general, it operates as a short-cut through the bankruptcy process, thereby providing the failed broker-dealer's customers with quicker access to their cash and securities. Part of this protection includes provisions for the trustee in the SIPA proceeding to make advances to customers up to \$500,000 per customer to be used to return securities or cash that are missing or otherwise not available to be returned. Consistent with FDIC protection, only \$100,000 of the \$500,000 maximum can be used to return cash. The advances and the other costs of a SIPA liquidation are financed through a fund maintained by the Securities Investor Protection Corporation (SIPC). If the trustee does not recover the amounts advanced from the estate of the failed broker-dealer, the SIPC fund incurs the loss (rather than the customer who received the advance).

The SIPA protections apply to cash and securities held at a broker-dealer, but not to futures positions. This result is a function of the SIPA definition of "security," which specifically excludes futures. Moreover, there is no corresponding statutory protection for futures customers under which they would receive advances if futures assets are missing. Because, as noted above, the NYSE and CBOE rules permit futures and futures options to be included in a portfolio where they will hedge offsetting positions in related securities, the question is raised as to how the futures positions should be treated in a SIPA liquidation of the broker-dealer. The SEC believes they should be protected under SIPA because their inclusion lowers the risk of the portfolio as a whole.

To assure SIPA protection to all products in these accounts, the SEC recommends that Congress amend certain definitions in SIPA. Such amendments could be very narrowly tailored to, in effect, provide that futures (including options on futures) held in a portfolio margin account under a SEC approved portfolio margin rule would receive SIPA protection. Thus, the amendments would extend SIPC protection to those products that are permitted to be deposited into a portfolio margin account that are hedging offsetting securities positions and, therefore, lowering the broker-dealer's risk of carrying the financed customer positions.

#### *Proposed Amendments Affecting the Definition of "Narrow-Based Security Index"*

The SEC is concerned that the proposal in Section 8 of S. 1566 to amend the definition of narrow-based index would remove the SEC's jurisdiction over futures on certain security indexes, which we believe would negatively impact investor protection and market integrity. Specifically, Section 8 of S. 1566 would direct the SEC and CFTC to exclude from the definition of "narrow-based security index" indexes based on specified types of instruments: (a) indexes based on foreign and U.S. debt securities; (b) indexes based on foreign equity securities; and (c) other U.S. securities. The blanket exclusion in Section 8 would eliminate key protections currently provided by the Federal securities laws, such as the registration and disclosure provisions of the Securities Act, to investors in futures based on the indexes (or the underlying securities) that this provision would exclude. Also, by excluding these indexes from the definition and giving the CFTC exclusive jurisdiction over futures on such indexes, futures exchanges would have the exclusive right to trade these products, and securities exchanges would be precluded from trading such instruments. The impact of this proposal is described further below.

*Indexes Based on Foreign and U.S. Debt.* Prior to the proposal of legislation to exclude debt indexes from the definition of "narrow-based security index," no parties had expressed interest to the SEC in trading futures based on debt indexes. That said, we agree that the current statutory definition of "narrow-based security index" does not appropriately distinguish between broad-based and narrow-based indexes of debt instruments.<sup>6</sup> However, we do not believe that legislative changes are nec-

<sup>6</sup>Specifically, an index is considered narrow-based if its lowest weighted component securities, in the aggregate, have average daily trading volume below \$50 million (\$30 million if the index has at least 15 securities). This requirement was intended to ensure that indexes of equity securities that are composed disproportionately of illiquid, and therefore more manipulable, securities are covered by the definition of "narrow-based security index." Individual debt securities do

essary to address this issue. In Section 3 of the Exchange Act, the limitations of the definition were contemplated by Congress, and joint authority was provided to the SEC and the CFTC to make determinations with respect to security indexes that do not meet the specific statutory criteria without regard to the types of securities that comprise the index.<sup>7</sup> The SEC and CFTC already have the tools necessary to exclude indexes composed of debt securities (United States or foreign), and we look forward to working with the CFTC to expeditiously address the trading of futures on debt indexes through joint action. To legislate such a change would make an unwarranted jurisdictional shift while limiting the flexibility of the two agencies to respond to interest in developing and trading new security futures products relating to debt indexes.

*Foreign Security Indexes.* Section 8 of S. 1566 would require the SEC and the CFTC to exclude from the definition of “narrow-based security index” indexes on foreign equities consistent with the capitalization, trading patterns, and trade reporting conditions in the foreign market. The SEC believes that it is important for the securities laws to apply to any index future that can be a surrogate for the index’s component securities. A future on a narrow-based index composed of foreign securities can be a surrogate for underlying securities in the same way that a narrow-based index composed of domestic securities can be. Whether or not an index is a surrogate of its component securities depends on the number, concentration, and liquidity of the securities composing the index. The capitalization, trading patterns, or trade reporting conditions in a particular foreign market are not determinative of whether a future on a particular index could be a surrogate for the index’s component securities.

Currently, the principal impediment to trading security futures on narrow-based indexes composed of foreign securities is the statutory requirement that all the securities underlying a security future be registered under Section 12 of the Exchange Act.<sup>8</sup> Because today all foreign stock indexes include unregistered securities, this requirement precludes U.S. exchanges from trading futures on such indexes if the indexes are “narrow-based.” By moving the jurisdictional line to deem such indexes “broad-based,” the requirement that underlying securities be registered under Section 12 would be removed. Thus, none of the protections of the securities laws would apply, including the prohibition on insider trading, raising market integrity, and investor protection concerns. Moreover, redefining an index as broad-based would grant futures exchanges a monopoly to trade futures on such indexes because broad-based index futures may only trade on futures exchanges.

The SEC believes that there is an alternative way to address the impediments to trading these products as security futures (that is, the Section 12 registration requirement), and SEC staff has shared this approach with CFTC staff. Specifically, the SEC and the CFTC have the authority to exempt security futures from the requirement that underlying securities be registered under Section 12 of the Exchange Act. The SEC believes such an exemption would be appropriate under certain circumstances, including where such products are only available to sophisticated investors. The SEC and its staff would welcome the opportunity to work with the CFTC to resolve this issue.

*Other U.S. Securities.* Finally, Section 8 of S. 1566 would require the SEC and the CFTC to exclude from the definition of “narrow-based security index” indexes on other U.S. securities. It is unclear what this provision contemplates; yet it directs the two agencies to agree to change the jurisdictional line established by the CFMA.

Prior to the enactment of the CFMA, futures exchanges were permitted to offer a futures contract on a securities index only if the futures contract satisfied certain statutory criteria, including a requirement that the underlying securities index measure and reflect the entire market or a substantial segment of the market.<sup>9</sup> In addition to lifting the ban on trading of futures contracts if they did not satisfy these criteria, the CFMA’s definition of “narrow-based security index” established a

not trade with the same regularity as equity securities. Therefore, it would be very difficult to create a debt index that does not fall within the definition of “narrow-based security index”—even if that index would be widely considered broadly based. Moreover, the frequency with which a particular debt securities trades is not a good indicator of whether it is susceptible to manipulation.

<sup>7</sup> See Section 3(a)(55)(C)(vi) of the Exchange Act, 15 U.S.C. 78c(a)(55)(C)(vi).

<sup>8</sup> 15 U.S.C. 78l.

<sup>9</sup> The jurisdictional agreement, commonly referred to as the “Shad-Johnson Accord,” was passed into law as part of both the Securities Acts Amendments of 1982 and the Futures Trading Act of 1982. See P.L. No. 97-303; 96 Stat. 1409 (1982) and 97-444; 96 Stat. 2294 (1982). Under the Shad-Johnson Accord, the CFTC retained exclusive jurisdiction over all futures contracts on broad-based security indexes. The agreement prohibited the trading of single stock futures and futures on narrow-based security indexes.

clear, objective standard for which indexes were narrow and which were broad. The SEC urges Congress not to reintroduce uncertainty into this area by establishing standards for determining jurisdictional boundaries that are subjective and subject to differing interpretations.<sup>10</sup> The SEC believes the current definition of “narrow-based security index” reasonably identifies those indexes of U.S. securities that are so small, highly concentrated, or illiquid that a future on such an index would be a surrogate for the underlying securities.

### Application of CEA to Foreign Currency Transactions

#### LEGAL CERTAINTY FOR OTC DERIVATIVES MARKETS

It is widely recognized that OTC derivative instruments are important financial management tools that, in many respects, reflect the unique strength and innovation of U.S. capital markets. Indeed, U.S. markets and market professionals have been global leaders in derivatives technology and development. The enormous size of the OTC derivatives market demonstrates its critical role in our capital markets. OTC derivative instruments provide significant benefits to corporations, financial institutions, and institutional investors by allowing them to isolate and manage risks associated with their business activities or their financial assets. These instruments, for example, can be used by corporations and local governments to lower funding costs, or by multinational corporations to reduce exposure to fluctuating exchange rates.

Legal certainty and regulatory clarity are essential to ensure that the United States continues to play a leading role with regard to innovation and growth in the OTC derivative market. An environment that lacks legal certainty could undermine the flexibility and competitiveness of the U.S. financial markets. The OTC Derivatives Report issued by the Working Group prior to the enactment of the CFMA contained several recommendations designed to address legal uncertainty regarding the application of the CEA to the execution and clearance of OTC derivatives products. In response, Congress sought in the CFMA to provide legal certainty and regulatory clarity in the OTC derivatives market. The SEC believes it is critical that these achievements be retained.

#### PROPOSED AMENDMENTS TO ADDRESS RETAIL FOREIGN CURRENCY FRAUD

The SEC has worked closely with staff of the other members of the Working Group on issues related to the sale of foreign currency products to retail customers. The goal has been to give the CFTC clear authority to take action against foreign-exchange boiler rooms without undermining the so-called Treasury Amendment, which excludes certain transactions in foreign currency from CFTC jurisdiction.

This effort is a response to the Seventh Circuit’s decision in *CFTC v. Zelener*,<sup>11</sup> upholding the dismissal of a CFTC fraud action on the grounds that certain leveraged contracts of sale for foreign currency marketed to retail customers were spot transactions, not futures contracts, and thus not subject to the CEA. As others have noted, the decision raised questions about the scope of the CFTC’s jurisdiction under the Treasury Amendment. S.1566 would address the *Zelener* decision by significantly expanding the jurisdiction of the CFTC.

The SEC believes that any change to the CEA should not be so broad as to affect the securities markets or the SEC’s ability to effectively oversee those markets. In its current form, S.1566 could do both by generating legal uncertainty regarding whether the CFTC would have jurisdiction over options on foreign currency that are traded on national securities exchanges and certain other securities, such as structured notes that reflect currency values. In addition, S.1566 would undermine the competitive parity between broker-dealers and banks in foreign currency transactions that Congress established in 2000 with the CFMA. The securities and banking industries rely on parallel exclusions from the CEA that were fashioned by the CFMA for foreign currency transactions. However, S.1566 would substantially curtail those exclusions for the securities industry by eliminating the exclusion for certain affiliates of broker-dealers. Because we have not seen evidence of involvement in retail foreign currency transaction fraud by these unregistered affiliates of broker-dealers, we do not believe it is appropriate to eliminate the exclusion.

The Working Group principals created a staff-level working group and directed their staff to work together to craft a legislative solution that would address the *Zelener* decision in a more targeted way than does S.1566. The Working Group has reached agreement in principle on how to address the issues raised by this decision.

<sup>10</sup> See *Board of Trade of City of Chicago v. SEC*, 677 F.2d 1137 (7th Cir. 1982), vacated as moot, 459 U.S. 1026 (1982); and *Chicago Mercantile Exchange v. SEC*, 883 F.2d (7th Cir. 1989); *Board of Trade of the City of Chicago v. SEC*, 187 F.3d 713 (7th Cir. 1999).

<sup>11</sup> 373 F.3d 861 (7th Cir. 2004).

The staff have met regularly over the past several weeks and is crafting legislative language that would grant the CFTC additional antifraud authority over a narrow category of leveraged transactions in foreign currency with retail customers by unregulated foreign exchange bucket shops, and a registration requirement for solicitors of such transactions. Important to the Commission is that this agreement would preserve the existing exclusion from the CEA for foreign currency transactions by certain broker-dealer affiliates, as well as other regulated financial institutions.

#### **Conclusion**

The SEC appreciates the opportunity to participate in the dialogue that S. 1566 has engendered regarding security futures products and derivative products. We look forward to working closely with this Committee, the Working Group, market participants, and other legislators as these issues continue to be considered.

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### **PREPARED STATEMENT OF PATRICK J. McCARTY**

GENERAL COUNSEL, COMMODITY FUTURES TRADING COMMISSION

SEPTEMBER 8, 2005

Mr. Chairman, Senator Sarbanes, and Members of the Committee, I appreciate the opportunity to appear on behalf of the Commodity Futures Trading Commission (CFTC) at this hearing on the reauthorization of the Commodity Exchange Act (CEA).

Congress's most recent exercise in reauthorizing the CEA resulted in the Commodity Futures Modernization Act of 2000 (CFMA). It was, most assuredly, landmark legislation under which the futures industry has flourished. This Committee deserves credit for its role in the CFMA's development. The CFTC concurs with the widely held view that this reauthorization—unlike the sweeping nature of the CFMA—should involve only incremental changes to the CEA.

The issue in this legislative round that has received the most public attention involves the CFTC's antifraud authority with respect to retail foreign currency transactions in light of the *Zelener* decision. *CFTC v. Zelener*, 373 F.3d 861 (7th Cir.), *rehearing denied en banc*, 387 F.3d 624 (7th Cir. 2004) (*Zelener*). I am pleased to note that the staff of the President's Working Group on Financial Markets (PWG) has reached an agreement in concept on a legislative recommendation to address the post-*Zelener* situation, though the final details are being worked out for approval by the PWG Principals.

I will cover today the issues the Committee specifically asked us to address, as well as two others of importance to the CFTC: (1) risk-based and portfolio margining for both security futures products (SFP's) and for security options; (2) clarification of exclusions from the CEA's definition of narrow-based security index; (3) the *Zelener*/retail foreign currency fraud consensus proposal endorsed by the PWG; (4) amendments to Section 4b of the CEA providing the Commission with clear "principal-to-principal" antifraud authority over off-exchange futures transactions; and (5) amendments to Section 9 of the CEA clarifying the Commission's authority to bring administrative and civil actions as well as increasing civil and criminal penalties.

#### **Risk-Based Portfolio Margining of Security Futures Products and Security Options**

Section 7 of the Senate Agriculture Committee bill as reported, S. 1566, provides for the institution of a pilot program for risk-based portfolio margining of SFP's. The CFTC supports risk-based and portfolio margining for both SFP's and security options.<sup>1</sup> Risk-based margining and portfolio margining, standard in the futures indus-

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<sup>1</sup> Risk-based margining, as opposed to strategy-based margining, establishes margin levels based upon an analysis of the historical performance and expected price volatility of individual products. Risk-based margin requirements are designed to cover the expected one-day price movement with an established level of statistical confidence (generally 99 percent). Risk-based portfolio margining establishes margin levels by assessing the net market risk of a portfolio of positions in an account. Portfolio margining is based upon the premise that combinations of positions can have offsetting risk characteristics due to historic or expected correlations in their price movements. Under a risk-based portfolio margining system, the minimum level of margin is determined by (1) analyzing the risk of each component position in an account and (2) recognizing any risk offsets in an overall portfolio of positions. Portfolio margining, as opposed to strategy-based margining, more accurately evaluates the economic risks of open positions, thereby minimizing the chance of over-margining or under-margining. In addition, portfolio mar-

try, are both efficient and effective from a regulatory point of view, and have been remarkably successful in protecting customer funds.

The use of a more risk-sensitive, portfolio-based approach to margining for financial products has received wide support. For example, the Federal Reserve Board of Governors expressed support for risk-based and portfolio margining in its March 2001 letter to the Securities and Exchange Commission (SEC) and CFTC delegating margin authority over SFP's. The Board specifically noted its expectation that the creation of this new product would promote opportunities for portfolio margining for all securities, including security options and SFP's.

The SEC has also taken steps that show support for risk-based and portfolio margining. On July 14, 2005, the SEC approved a Chicago Board Options Exchange (CBOE) 2-year pilot program for portfolio margining and cross margining<sup>2</sup> with respect to certain products. On the same date, the SEC also approved New York Stock Exchange (NYSE) rule changes that would enable NYSE members to participate in the CBOE pilot program. However, SFP's are not included in the portfolio margining provisions of the pilot program, and therefore it would not directly facilitate the use of portfolio margining for these products. In addition, while broad-based securities index futures and broad-based equity options are included in the cross-margining provisions of the pilot program, they must be held in a securities account in order to receive the benefit of cross-margining; market participants should have the choice to have margin held in a futures account if they so desire.

The CBOE pilot program has similarities to the pilot program for SFP's found in Section 7 of the Senate Agriculture Committee bill insofar as the CBOE program permits portfolio margining. The CFTC urges Congress to enact legislation that will allow firms and their customers to benefit from the use of risk-based portfolio margining systems.

#### **Clarification of Narrow-Based Security Indexes**

Section 8 of S.1566 as reported by the Senate Agriculture Committee directs the SEC and the CFTC to undertake a joint rulemaking that would exclude certain types of indexes from the definition of "narrow-based security index." In the CFMA, Congress determined that SFP's, which include "narrow-based security indexes," would be subject to joint regulation by the SEC and the CFTC. At the same time, Congress directed the SEC and the CFTC to issue rules defining both broad- and narrow-based security indexes for foreign securities markets.<sup>3</sup> Neither set of rules has yet been promulgated. Further, Congress, in the CFMA, provided the SEC and CFTC with the authority to exclude certain other types of indexes and instruments from the definition of "narrow-based security index."<sup>4</sup> The agencies have not acted to exclude certain types of indexes which we believe Congress did not intend to be regulated as SFP's. Legislation to compel a joint SEC/CFTC rulemaking in this area would be appropriate to provide legal certainty to market participants, and to give effect to the intent of Congress when it enacted the CFMA, which we understand was to make these products available to U.S. investors.

The Senate Agriculture Committee bill would not cause the SEC to lose jurisdiction or alter the prior jurisdictional division between the agencies but, rather, would add needed clarification regarding the classification of these products. The CFTC has had exclusive jurisdiction over futures on broad-based security indexes, and options on such futures, for well over 20 years. These markets have operated effectively under CFTC oversight. Prior to enactment of the CFMA in 2000, approximately 100 futures contracts on broad-based security indexes—both domestic and foreign—were approved for trading by the CFTC in coordination with the SEC.<sup>5</sup> In the CFMA, Congress preserved the CFTC's exclusive jurisdiction over futures on broad-based security indexes. Congress provided joint jurisdiction with the SEC only

gining acknowledges the reality that an offsetting position can be a better risk mitigant than deposited collateral.

<sup>2</sup>Cross-margining is a type of risk-based margining that jointly margins related products (securities, options, and futures contracts) that are traded in different markets and generally cleared by different clearing entities.

<sup>3</sup>See CEA Section 1a(25)(C) and Securities Exchange Act Section 3a(55)(D)(joint broad-based rulemaking), and CEA Section 2(a)(1)(E)(i) and Securities Exchange Act Section 6(k)(1)(joint narrow-based rulemaking). CEA Section 2(a)(1)(E)(ii) and Securities Exchange Act Section 6k(2) specifically require that, in promulgating rules pursuant to Sections 2(a)(1)(E)(i) and 6(k)(1), the agencies shall take into account the nature and size of the markets underlying the foreign security index.

<sup>4</sup>CEA Section 1a(25)(B)(vi).

<sup>5</sup>See Appendix A.

over futures on single stock and narrow-based security indexes—CEA § 2(a)(1)(D)—not with respect to futures on broad-based security indexes.<sup>6</sup>

It has been 5 years since enactment of the CFMA. The agencies have not adopted rules for foreign security indexes and debt security indexes because of divergent views over whether the current narrow-based security index test applies to those markets and indexes. It is appropriate at this time to provide more statutory clarity regarding what constitutes a broad-based security index. Congress should act to provide legal certainty to market participants and to regulators, and at the same time allow for innovation and competition in these markets.

Further, we believe that the four broad-based security index definitions that we have developed are reasonable and consistent both with past CFTC practice in approving futures on broad-based security indexes, and with Congressional intent in enacting the CFMA. In brief, these definitions relate to: (1) foreign security indexes; (2) U.S. debt security indexes; (3) foreign debt security indexes; and (4) a general broad-based security index definition. These four definitions are more fully described in Appendix B.

The current statutory test for “narrow-based security indexes” is quite detailed and was tailored to fit the U.S. equity market.<sup>7</sup> In addition, the CFMA included a “nonnarrow-based” security index test.<sup>8</sup> These current statutory tests for narrow- and nonnarrow-based security indexes are appropriate for the U.S. equity market, which is the largest, deepest, and most liquid securities market in the world by far.

These tests were not designed to apply to foreign markets, as most of these countries do not list even 200 equity securities—let alone 675 securities as contemplated by the “nonnarrow-based” test. In addition, foreign equities generally are not registered under Section 12 of the Securities Exchange Act of 1934, and so it is difficult, if not impossible, to meet the current nonnarrow-based security index test. With regard to indexes that are currently not being offered in the United States (due in large part to the barrier to entry created by the current narrow-based security index test), CFTC economists have identified numerous well-established foreign indexes that would not meet the current test, but which should be considered broad-based under a test that more accurately takes into account the nature, size, and character of foreign markets (as required by the CFMA).<sup>9</sup> (See Appendix C.) This point is evidenced by the clear language of the CFMA, which mandated that in developing joint foreign narrow-based security index product rules, the Agencies should consider the size and nature of the markets underlying the foreign indexes.<sup>10</sup>

In addition, application of the current narrow-based security index test in foreign markets results in strange anomalies. Several well-known foreign security indexes that are currently trading as broad-based indexes pursuant to the “grandfather” provision in the CFMA—the IBEX-35 (Spain); the Hang Seng (Hong Kong); the MSCI Singapore Free; and the MSCI Hong Kong—would not meet the current statutory test. This results in a situation in which existing indexes may continue to trade, but an identical new index that is required to meet the current “narrow-based security index” test could not qualify to trade. These anomalous results, and the

<sup>6</sup>The SEC has explicitly acknowledged the CFTC’s exclusive jurisdiction over futures on broad-based security indexes on many occasions. In 1983, an SEC no-action letter stated, “The Commodity Futures Trading Commission (CFTC) has *exclusive jurisdiction over . . . futures contracts on broad-based indices of any securities*.” See Granite Fund, SEC No-Action Letter, October 31, 1983. The SEC again acknowledged the CFTC’s exclusive jurisdiction more recently, in 2002, in the joint order issued by the SEC and the CFTC excluding certain security indexes from the definition of “narrow-based security index” under the CEA and the Federal securities laws. The CFTC/SEC Joint Order on Grandfathered Security Indexes stated, “[t]o distinguish between security futures on narrow-based security indexes, which are jointly regulated by the Commissions, and futures contracts on broad-based security indexes, *which are under the exclusive jurisdiction of the CFTC . . .*” (emphasis added). 67 Fed. Reg. 38,941 (June 6, 2002).

<sup>7</sup>The statutory test for “narrow-based security indexes” provides that an index will be considered “narrow-based” if: (1) it has nine or fewer components; (2) one of the component securities comprises more than 30 percent of the index’s weighting; (3) the five highest weighted component securities in the aggregate comprise more than 60 percent of the index’s weighting; or (4) the value of average daily trading volume of the bottom quartile of the index, by weight, falls below \$50 million (or below \$30 million in the case of indexes with 15 or more component securities). CEA Section 1a(25)(A), Securities Exchange Act Section 3a(55)(B).

<sup>8</sup>The statutory test for a “nonnarrow-based security index” provides that a security index will be considered “nonnarrow” if: (1) it has at least nine component securities; (2) no component security comprises more than 30 percent of the index’s weighting; and (3) each component security is registered under Section 12 of the Securities Exchange Act, is one of 750 securities with the largest market capitalization, and is one of 675 securities with the largest dollar value of average daily trading volume. CEA Section 1a(25)(B), Securities Exchange Act Section 3a(55)(C).

<sup>9</sup>Application of the current narrow-based security index definition almost certainly means that all foreign industry and sector indexes will be considered to be narrow-based.

<sup>10</sup>CEA Section 2(a)(1)(E)(ii), Securities Exchange Act Section 6(k)(2).

clear language of the statute, evidence that Congress did not intend to apply the narrow-based security index test to foreign markets.

Similar difficulties occur in attempting to apply the current statutory definition to domestic debt securities. Additionally, it is very clear that Congress intended U.S. Government debt to be excluded from the definition of SFP's. And the language of the CFMA indicates that Congress did not intend for foreign government debt or agency debt to be traded under the dual SFP regulatory scheme.<sup>11</sup> The market capitalization and quartile tests, and particularly the trading volume measures, in the narrow-based security index test are not appropriate for these markets. To illustrate this point, after passage of the CFMA, the agencies were contacted by the Chicago Board of Trade (CBOT), which wanted to increase the number of component securities (from 40 securities to 200 securities) in its existing municipal debt security index. However, the data was not available to evaluate the volume requirement of the test, and so the new (200-security) index could not pass the statutory test. This would seem to defy common sense. If the old (40-security) index contract was considered broad-based, then there is something wrong with the current definition if it will not accommodate as broad-based the same index with 200 underlying securities. The result has been a barrier to entry, such that exchanges simply do not attempt to offer futures on broad-based debt security index contracts to the marketplace.

Accordingly, a separate test is needed for domestic debt securities. And because foreign debt markets are significantly different from U.S. debt and equity markets, there also needs to be an appropriately crafted test developed specifically for foreign debt security indexes.

The Senate Agriculture Committee bill would promote clarity in this area by requiring the CFTC and the SEC to jointly promulgate final rules within 180 days. It also provides criteria that the CFTC and the SEC are to use in excluding indexes on U.S. debt instruments, foreign equities, foreign debt instruments, and other U.S. securities from the definition of "narrow-based security index." As noted above, the CFTC has developed specific definitions to address each area<sup>12</sup> that would tailor the rules for foreign equity markets (which are significantly smaller than U.S. equity markets) and debt instruments (which are inherently unable to meet the current volume and market capitalization tests in the statute) based on the size and nature of those markets, and on the potential for insider trading and market manipulation. Either these definitions should be codified, or joint regulations adopting such definitions should be issued. These definitions would address a significant problem, and are consistent with the language in the CFMA.

### **The Zelener Decision/Foreign Currency Fraud**

With regard to the adverse impact of the Seventh Circuit Court of Appeals decision in the *Zelener* case on the CFTC's ability to combat retail foreign currency (forex) fraud, the CFTC continues to believe that the *Zelener* case was wrongly decided and that the contracts at issue in that case were futures contracts. We therefore urge Congress to restore legal certainty by clarifying the CFTC's jurisdiction in this area.

Retail forex fraud is a significant concern for the CFTC. In the last 4 years, the CFTC has brought 79 enforcement actions involving forex fraud against unsuspecting retail customers. In these 79 cases, there were 23,000 victims who invested approximately \$350 million. Courts have awarded approximately \$267 million in customer restitution and civil penalties in these cases. The Commission has been able to recover some funds for distribution to customers, but the total amount of funds frozen and/or distributed is less than \$15 million.

There are divergent views over whether Congress should address the *Zelener* decision broadly with respect to all commodities, or narrowly with a "forex-only" solution. The Commission transmitted legislative language limited to forex to the Senate Agriculture Committee on May 20, 2005, and noted at the time that the legislative package "represents a consensus among the Commissioners and the minimum which the Commission believes it needs in terms of change to the Commodity Exchange Act during reauthorization."

<sup>11</sup>There is a long history of futures being offered on U.S. Treasury bonds, notes, and bills at the Chicago Board of Trade (CBOT). The same can be said for futures on German Government bund, bobl, and schatz, first at the London Stock Exchange, then Eurex, and most recently at Eurex US and the CBOT. There is no evidence that Congress, in enacting the CFMA, had any intention of requiring futures on these government debt instruments to be SFP's subject to joint CFTC/SEC jurisdiction, as opposed to being solely subject to the CFTC's exclusive jurisdiction. It may be appropriate at this time to consider statutory or regulatory revisions to broaden the list of exempted securities that may appropriately underlie futures contracts and be included as component securities in debt security index contracts.

<sup>12</sup>See Appendix B.

As you may know, the staff of the PWG members met at least weekly during the month of August with respect to the *Zelener* issue. As noted in the introduction, PWG staff has reached agreement in concept on a *Zelener* solution that it believes will give the CFTC adequate authority to address the significant retail forex fraud problem.

The final details of the language are being worked out for approval by the PWG Principals. I would note, though, that the staff believes the concept would provide the CFTC with fraud authority over retail forex “futures look-alike” contracts, and thus specifically address the problem raised by the *Zelener* decision. It would address the significant problem that our enforcement staff has faced in the investigation and prosecution of fraudulent bucket shops and solicitors who prey upon retail customers in the forex arena.

The proposed language, however, would apply only to certain retail foreign currency transactions—futures and “futures look-alike” contracts as were involved in the *Zelener* case. Its scope is narrow, as it also makes clear that legitimate spot transactions (such as the purchase of foreign currency at a currency exchange) are not included within the jurisdiction of the CFTC.

The proposal also would retain the current “otherwise regulated” scheme established in the CFMA, whereby retail foreign currency transactions by financial institutions such as banks, broker-dealers, and insurance companies are excluded from the CFTC’s jurisdiction. The CFMA excluded these “otherwise regulated” financial institutions based on the premise that their regulators will oversee, examine, and bring fraud actions if there are problems. SEC-registered broker-dealers will not be required to register with the CFTC in order to engage in off-exchange forex transactions with retail customers. They will still be able to rely upon the “otherwise regulated” exclusion in the statute, subject to the review and oversight of the SEC.

Finally, it is important to reiterate that the CFTC continues to believe that *Zelener* was wrongly decided. We believe that the foreign currency contracts that were the subject of that controversy were futures contracts, and that they were not excluded spot contracts because no deliveries of foreign currency were ever made to any customers under any of the contracts. We also note that the court in *Zelener* determined that there clearly was fraud involved. The CFTC will continue to litigate this issue vigorously to protect customers against precisely this type of fraud and abuse.

#### **Principal-to-Principal Antifraud Authority**

Section 2 of S.1566 amends Section 4b of the CEA to address an important issue relating to the CFTC’s antifraud authority. Section 4b, the CFTC’s main antifraud provision, has been amended in this bill to clarify that the CFTC has the authority to bring fraud actions in off-exchange “principal-to-principal” futures transactions. These changes are necessary to eliminate significant obstacles to the use of the CFTC’s antifraud authority in today’s nonintermediated markets.

In late November 2000, the Seventh Circuit Court of Appeals ruled that the CFTC could use Section 4b only in “intermediated” transactions—those involving a broker-customer relationship. *Commodity Trend Service, Inc. v. CFTC*, 233 F.3d 981, 991–992 (7th Cir. 2000)(CTS). In other words, the court ruled that the CFTC cannot use its Section 4b antifraud authority in “principal-to-principal” transactions. Meanwhile, at about the same time, the CFMA amended the CEA to permit off-exchange futures and options transactions that are done on a principal-to-principal basis, such as energy transactions pursuant to CEA Sections 2(h)(1) and 2(h)(3). Congress specifically reserved the CFTC’s Section 4b antifraud authority in Section 2(h) so that the CFTC could prosecute fraud involving transactions conducted under that Section of the CEA. Since *all* Section 2(h) transactions *must* be done on a principal-to-principal basis to qualify for the exemption, it is important to clarify that Section 4b antifraud authority applies to nonintermediated transactions. Without this clarification, the work of Congress in 2000 to protect energy markets from fraud could be rendered meaningless.

Accordingly, the Senate Agriculture Committee’s reported bill amends subsection 4b(a)(2) by adding the words “or with” to address off-exchange principal-to-principal transactions. This new language would make it clear that the CFTC has the authority to bring antifraud actions in off-exchange principal-to-principal futures transactions, including exempt commodity transactions in energy under Section 2(h) as well as all transactions conducted on derivatives transaction execution facilities. This amendment to Section 4b would implement Congressional intent to reserve the CFTC’s antifraud authority with regard to principal-to-principal transactions.

In addition, the amended Section 4b would clarify that market participants in these transactions are not required to disclose information that may be material to the market price, rate, or level of the commodity in such off-exchange transactions.

It also would codify, however, existing law that prohibits market participants from using “half-truths” in negotiations and solicitations by requiring necessary disclosures to protect against materially misleading statements.

I note that the Section 4b language is supported by the Futures Industry Association, the National Futures Association, the Chicago Mercantile Exchange, the Chicago Board of Trade, the New York Mercantile Exchange, Eurex U.S., and others.

#### **Civil and Administrative Actions under Section 9**

Section 3 of S. 1566 amends CEA Section 9 by adding a new subsection 9(f) that would clarify the CFTC’s authority to bring civil and administrative actions. Under Section 9 of the CEA, it is a felony for any person to knowingly make false, misleading, or inaccurate reports regarding the price of any commodity—including electricity and natural gas. Most of the other provisions of Section 9 similarly identify types of misconduct that constitute felonies. The CFTC lacks criminal powers, but it has brought civil enforcement proceedings under Section 9 throughout its history. In fact, in the last 25 years the CFTC has brought over 70 civil injunctive or administrative enforcement actions under Section 9.

In the last 3 years, the CFTC has used Section 9 to achieve approximately 30 significant monetary settlements, totaling nearly \$300 million in civil monetary penalties, for “false reporting” by energy trading firms or their traders in violation of CEA Section 9. In many of these cases, the energy trading firms or their traders reported a very large number of fictitious transactions, or reported significantly altered data about transactions, to publications that compile and publish natural gas price indexes. The reporting was done in an attempt to manipulate index prices.

Energy firms and traders have argued that the reporting of fictitious transactions and significantly altered data about transactions is excluded from the CFTC’s jurisdiction by Section 2(g) of the CEA. The CFTC has consistently taken the position that, even if a transaction is excluded from CFTC jurisdiction under Section 2(g), the false reporting of such a transaction is a separate act that remains a violation of Section 9 that the CFTC has authority to prosecute. On August 1, 2005 the CFTC’s position regarding false reporting and the scope of the exclusion under Section 2(g) (and the related exemption under CEA Section 2(h)) were upheld in *CFTC v. Bradley*, Case No. 05–CV–00062–JHP–FHM (N.D. OK August 1, 2005). This is the first reported decision in this area, and an extremely important one that affirms the CFTC’s authority and ability to prosecute false reporting cases under CEA Section 9.

Even with the *Bradley* decision, we feel a legislative change to Section 9 is still necessary because it would clarify the CFTC’s authority to bring civil and administrative actions, and would ensure that the CFTC can continue to bring false reporting cases in the energy arena for acts or omissions that occurred prior to enactment. The Senate Agriculture Committee bill expressly provides that these amendments restate, without substantive change, existing CFTC civil enforcement authority. This clarifying change does not grant any new statutory authority, and provisions of Section 9, as restated, continue to apply to any action for any alleged violation occurring before, on, or after the date of enactment.

Section 3 of S. 1566 also amends CEA Section 9 to double the civil and criminal penalties available for certain criminal violations of the CEA such as manipulation, false reporting, and conversion. The maximum fines under Section 9 would be increased from \$500,000 to \$1 million, and the maximum prison sentence would be increased from 5 to 10 years. In a similar vein, Section 3 of S. 1566 includes conforming amendments to the procedural enforcement provisions in Sections 6(c), 6b, and 6c of the CEA to effectuate this increase in civil monetary penalties.

I note that the Section 9(f) statutory language is consensus language that has been agreed to by the Futures Industry Association, the Chicago Mercantile Exchange, the Chicago Board of Trade, the New York Mercantile Exchange, Eurex U.S., and others.

#### **Conclusion**

The CFTC’s reauthorization is a unique opportunity to address the five areas that I have mentioned: Portfolio margining for security futures products and security options; clarification of definitions applicable to broad-based foreign security indexes and debt indexes; the *Zelener*/forex fraud provision; the CEA’s principal-to-principal antifraud authority; and increased penalties and clarification of civil and administrative authority. The CFTC is eager to work with the Congress to successfully complete reauthorization of the CFTC this year. Thank you for the opportunity to testify on these important matters.

**Appendix A****BROAD – BASED SECURITY INDEXES****CBOE FUTURES EXCHANGE**

Mini-Russell 2000 Index (RT)  
 Russell 1000 Index (RN)  
 Mini-Russell 1000 Index (RX)  
 DJIA Volatility Index (DV)  
 S&P 500 Three-Month Variance (VT)  
 CBOE China Index (CX) (F)  
 CBOE Pharmaceuticals Index (PGF)  
 CBOE Telecom Index (PQ)  
 CBOE Volatility Index (VX)

**CHICAGO BOARD OF TRADE**

Dow Jones Industrial Index  
 Mini Dow Jones Industrial Index

**CHICAGO MERCANTILE EXCHANGE**

Nikkei 225(\$)(F)  
 Nikkei 225(Yen)(F)  
 S&P 500 Index  
 E-mini S&P 500  
 S&P Financial Sector  
 S&P Technology- Telecomm Sector  
 S&P Smallcap 600  
 S&P Midcap 400 Index  
 E-mini S&P Midcap 400  
 S&P Barra Growth Index  
 S&P Barra Value Index  
 Russell 2000  
 E-mini Russell 2000  
 E-mini Russell 1000  
 Nasdaq 100  
 E-mini Nasdaq 100  
 E-mini Nasdaq Composite  
 Long-Short TRAKRS  
 Long-Short TRAKRS II  
 LMC TRAKRS  
 TRAKRS Select 50

F = Foreign

**Appendix A****EUREX US**

Russell 2000  
 Russell 1000

**KANSAS CITY BOARD OF TRADE**

Value Line Index

**NEW YORK BOARD OF TRADE**

Revised NYSE Composite Index  
 Russell 1000  
 Russell 1000 Growth Index  
 Russell 1000 Value Index  
 Russell 2000 Index

\* \* \*

**FOREIGN NO- ACTION INDEXES**

**AE -- The Amsterdam Exchanges (formed by the merger of the Financieel Termijnmarkt Amsterdam and the European Options Exchange):**

- Eurotop 100 Index futures contract†

**ASXF -- ASX Futures Exchange:**

- S&P/ASX 50 futures contract
- S&P/ASX 200 futures contract

**EDX -- EDX London Exchange (formerly traded on OM London Exchange, Ltd.):**

- OMX Stock Index Standardized futures contract†
- OMX Stock Index Flexible futures contract†

**EUREX -- Eurex Deutschland (formerly DTB, Deutsche Terminbörse):**

- Dow Jones Global Titans 50 futures contract
- Dow Jones STOXX 600 Banking Sector Index futures contract
- Dow Jones EURO STOXX Banking Sector Index futures contract
- Dow Jones STOXX 50 Index futures contract†

**Appendix A**

- Dow Jones EURO STOXX 50 Index futures contract†
- Deutsche Aktienindex (DAX) Stock Index futures contract†

**EURONEXT -- Euronext Amsterdam, N.V.:**

- AEX Index futures contract
- Light AEX Index futures contract

**HKFE -- Hong Kong Futures Exchange:**

- Hang Seng Index futures contract†
- HKFE Taiwan Index futures contract†

**INTEX -- International Futures Exchange (Bermuda) Ltd.:**

- Financial News Composite Index futures contract†

**IDEM -- Italian Stock Exchange (Mercato Italiano dei Derivati):**

- MIB 30 Index futures contract†
- MiniFIB futures contract
- S&P/MIB Index futures contract
- Mini S&P/MIB Index futures contract

**JSE -- JSE Securities Exchange South Africa:**

- FTSE/JSE 40 Top companies Index futures contract

**LIFFE -- London International Financial Futures and Options Exchange:**

- Morgan Stanley Capital International Pan-Euro Index futures contract†
- Morgan Stanley Capital International Euro Index futures contract†
- FTSEurofirst 80 Index Futures Contract
- FTSEurofirst 100 Index Futures Contract
- FTSE International Eurobloc 100 Index futures contract†
- FTSE International Eurotop 300 Index futures contract†
- FTSE International Eurotop 300 (ex. UK) Index futures contract†
- FTSE International Eurotop 100 Index futures contract†
- Financial Times-Stock Exchange 100 Index futures contract†
- Financial Times Mid-250 Index futures contract (FTSE Mid-Cap)†
- Mini FTSE 100 Index futures contract

**Appendix A****MEFF RV (Meff Renta Variable) -- Meff Sociedad Holding Rectora de Productos Financieros Derivados, S.A. (Spain):**

- IBEX-35 Stock Index futures contract†
- S&P Euro Index futures contract
- S&P Europe 350 Index futures contract

**ME -- Montreal Stock Exchange:**

- S&P/TSE 60 Stock Index futures contract†

**MONEP -- Marché des Options Négociables de Paris:**

- CAC 40 Index futures contract†
- Dow Jones STOXX 50 Index futures contract†
- Dow Jones EURO STOXX 50 Index futures contract†

**NSE --The National Stock Exchange of India, Limited:**

- S&P CNX Nifty Index futures contract

**OM London Exchange Ltd. (formerly OMLX, London Securities and Derivatives Exchange, Ltd.):**

- OMX Stock Index Standardized futures contract†
- OMX Stock Index Flexible futures contract†
- OMXCAP Index Standardized futures contract†
- OMXCAP Index Flexible futures contract†

**OM -- OM Stockholm Exchange AB:**

- OMX Stock Index Standardized futures contract†
- OMXCAP Index Standardized futures contract†

**OSE -- Osaka Securities Exchange**

- FTSE Japan Index futures contract
- MSCI Japan Index futures contract
- Nikkei Stock Index 300 futures contract (Nikkei 300)†
- Nikkei Stock Average Index futures contract (Nikkei 225)†
- Russell/Nomura Prime Index futures contract

**Appendix A****SGX-DT -- Singapore Exchange Derivatives Trading, Limited (formerly SIMEX, the Singapore International Monetary Exchange):**

- SGX MSCI Japan Index futures contract
- Morgan Stanley Capital International Singapore Free Stock Index futures contract†
- Morgan Stanley Capital International Hong Kong Stock Index futures contract†
- Morgan Stanley Capital International Taiwan Stock Index futures contract†
- Nikkei Stock Average futures contract†
- Nikkei Stock Index 300 futures contract (Nikkei 300)†
- S&P CNX Nifty Index futures contract

**SFE -- Sydney Futures Exchange Ltd.:**

- All Ordinaries Share Price Index futures contract†
- S&P/Australian Stock Exchange 200 Index futures contract†

**TAIFEX -- Taiwan Futures Exchange:**

- Taiwan Stock Exchange Capitalization Weighted Stock Index futures contract
- Taiwan Stock Exchange Electronic Sector Index futures contract\*
- Taiwan Stock Exchange Finance Sector Index futures contract\*
- Mini Taiwan Stock Exchange Capitalization Weighted Stock Index futures contract

**TSE -- Tokyo Stock Exchange:**

- Tokyo Stock Price Index futures contract (TOPIX)†
- S&P/Topix 150 Index futures contract

**TFE -- Toronto Futures Exchange:**

- Toronto Stock Exchange (TSE) 300 Composite Index futures contract†
- TSE 100 Index futures contract†
- TSE 300 Spot Index†
- TSE 35 Index futures contract†
- TSE 35 Spot Index†

**PENDING APPROVAL:****Foreign Stock Index Futures Contracts Pending No-Action****BSE - The Bombay Stock Exchange (The Stock Exchange, Mumbai):**

- BSE Sensitive Index of 30 Stocks futures contract

**Appendix A****Eurex -- Eurex Deutschland**

- Dow Jones Italy Titans 30 futures contract

**HKFE -- Hong Kong Futures Exchange\***

- Hang Seng China Enterprises Index futures contract

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**\* NOTE:** The Commodity Futures Modernization Act of 2000 (CFMA), which was enacted on December 21, 2000, establishes a framework for the regulation of the offer and sale in the United States of futures contracts on security indexes. Among other things, the CFMA permits the continued offer and sale in the United States until at least June 21, 2002 of broad-based security index futures contracts traded on foreign futures and options exchanges that were authorized before the CFMA was enacted. These futures contracts, which received no-action relief from the Commission or its staff prior to December 21, 2000, are denoted with a ("+") on the approved list that appears below. All other futures contracts on the approved list below were authorized by no-action relief granted by Commission staff after December 21, 2000.

**(Items Updated in this Edition Are Denoted with an Asterisk \*)**

## **Appendix B**

### **Proposed New Broad-Based Security Index Definitions**

**Background:** Pursuant to Section 2(a)(1)(C)(ii) of the CEA, futures contracts on broad-based security indexes fall within the exclusive jurisdiction of the CFTC, as opposed to security futures on narrow-based security indexes, which are jointly regulated by the CFTC and the SEC.<sup>1</sup> The CFTC has developed four new broad-based security index definitions to be included in Section 1a of the CEA.<sup>2</sup> These new definitions relate to: (i) broad-based foreign security indexes; (ii) broad-based debt security indexes; (iii) broad-based foreign debt security indexes; and (iv) a general broad-based index definition. Also included is a conforming change to Section 2(a)(1)(C)(ii) to confirm that these indexes would be included within the CFTC's exclusive jurisdiction. Accordingly, futures contracts on these broad-based indexes would fall within the long-standing exclusive jurisdiction of the CFTC, and would be traded solely pursuant to CFTC rules and regulations applicable to such transactions. Each of these four new proposed definitions is discussed below.

#### **1. Broad-Based Foreign Security Index:**

This proposed definition is based on a concept developed by CFTC staff in connection with earlier attempts to promulgate a joint broad-based foreign security definition with the SEC.<sup>3</sup> This proposed definition differs from the basic requirements of the domestic "narrow-based" definition (found in CEA Section 1a(25)(A)) in that it takes into account the generally smaller size and more concentrated nature of foreign markets. For example, the domestic "narrow-based" definition includes a concentration test for the five most heavily weighted securities and a significant volume requirement. If the "narrow-based" test were applied to foreign markets, it would catch several well-established broad-based foreign security indexes based on these volume and weighting requirements that Congress set for the U.S. equity markets, but clearly did not intend for other markets.

In order to ensure that appropriate broad-based foreign security indexes, including sector indexes, would qualify as broad-based indexes under the exclusive jurisdiction of the CFTC, the proposed definition:

- maintains the domestic 30 percent weighting requirement, and

<sup>1</sup> The SEC and CFTC acknowledged CFTC exclusive jurisdiction over broad-based indexes in their Joint Order excluding certain security indexes from the definition of narrow-based security index under the CEA and the federal securities laws, 67 Fed. Reg. 38,941 (June 6, 2002) ("To distinguish between security futures on narrow-based security indexes, which are jointly regulated by the Commissions, **and futures contracts on broad-based security indexes, which are under the exclusive jurisdiction of the CFTC . . .**") (emphasis added).

<sup>2</sup> These proposals do not contemplate any amendment to existing CEA definitions for "narrow-based" and "non-narrow-based" security indexes, provisions that are mirrored in federal securities laws.

<sup>3</sup> CFTC staff developed this concept pursuant to the mandate of the CFMA that the SEC and CFTC promulgate joint broad-based foreign security index rules. The SEC and CFTC acknowledged their obligation in this regard in their joint definitional security futures product release, 66 Fed. Reg. 44,489 at 44,502 (August 21, 2001) ("The Commissions recognize their obligation jointly to adopt rules or regulations that set forth the requirements that a future on a security index traded on or subject to the rules of a foreign board of trade must meet in order for the index to be excluded from the definition of narrow-based security index.").

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- includes an additional weighting test (in lieu of the concentration and volume tests discussed above) that is tailored to the nature and size of foreign securities markets. These provisions ensure that no single security outweighs others in the index such that the stock dominates the index.

**Statutory Language:** Section 1a of the CEA (7 U.S.C. 1a) is amended by inserting at the appropriate places the following:

( ) BROAD-BASED FOREIGN SECURITY INDEX.—

(A) IN GENERAL.—The term “broad-based foreign security index” means any index in which the component securities in the index:

- (i) are issued by entities organized pursuant to the laws of a country other than the United States; and
- (ii) are issued by at least nine unaffiliated entities.

(B) SINGLE COMPONENT SECURITIES.—For purposes of complying with subparagraph (A), no component security in the index (or aggregate of affiliated component securities) may comprise more than 30 percent of the index’s weighting.

(C) INDEX WEIGHTING REQUIREMENTS.—The five highest weighted component securities in a broad-based foreign security index (or the aggregate of “affiliated component securities” in the index, as defined in subparagraph (D)), shall comprise:

- (i) no more than 60 percent of the index’s weighting; or
- (ii) no more than 80 percent of the index’s weighting if, in addition, the aggregate market capitalization of the component stocks in the index:
  - (a) averaged at least \$40 billion during the preceding 12 calendar months; and
  - (b) represent, on average, at least 50 percent of the total market capitalization of the underlying securities market.

(D) AFFILIATED COMPONENT SECURITIES.—For purposes of determining whether component securities in the index are “affiliated component securities” in the index, entities issuing component securities shall be deemed to be affiliated if 30 percent or more of each entity is under common control or ownership.

(E) GRANDFATHERED BROAD-BASED FOREIGN SECURITY INDEXES.—A broad-based foreign security index shall include any index that has received permission, in accordance with the requirements of section 2(a)(1)(C) of this Act, to be offered and sold to United States persons prior to the date of enactment of this paragraph.

## **2. Broad-Based Debt Security Index:**

The rationale for a separate broad-based debt security index definition is that the definition currently found in the CEA is an equity-based definition, and was not developed to accommodate debt securities. Unfortunately, debt security indexes will almost always be considered “narrow-based,” primarily due to the volume requirements included in the current “narrow-based” index definition. Accordingly, there should be a separate definition for debt security indexes. (Conversely, futures contracts on individual government securities have a long

**Appendix B**

history of trading on organized exchanges under the CFTC's exclusive jurisdiction pursuant to CEA Section 2(c)(2)(A).)

In addition, until very recently there had been no centralized transaction reporting system for debt securities, making the required calculations under the current definition difficult, if not impossible. This also made it difficult accurately to assess the size of these markets, which precluded trading futures contracts on these indexes as broad-based indexes within the exclusive jurisdiction of the CFTC under the current statutory definitions. To address this issue, the proposed definition:

- requires that the index not be dominated by a single security by including a 30 percent weighting requirement applicable to individual debt issuers, intended to ensure that events specific to that entity would not have a disproportionate impact on the index.
- explicitly allows municipal securities to be included in the index. Although such securities are exempted from registration with the SEC, futures trading on such securities is permitted only in the form of a broad-based securities index. Due to the transaction reporting system issues noted above, it has been difficult to assess whether a debt security index including municipal bonds would be considered anything other than a narrow-based index under the current volume test. Accordingly, the proposed broad-based debt security index definition specifically includes municipal bonds.

**Statutory Language:** Section 1a of the CEA (7 U.S.C. 1a) is amended by inserting at the appropriate places the following:

( ) BROAD-BASED DEBT SECURITY INDEX.—

(A) IN GENERAL.—The term “broad-based debt security index” means any index in which:

- (i) the component securities in the index are debt obligations, as defined in section 2(a)(1) of the Securities Act of 1933 and in section 3(a)(1) of the Securities Exchange Act of 1934;
- (ii) the component securities (including municipal securities as defined in section 3(a)(29) of the Securities Exchange Act of 1934 on the date of enactment of the Futures Trading Act of 1982) in the index are issued by at least nine unaffiliated entities;
- (iii) the debt of a single entity issuing component securities in the index (or the aggregate of “affiliated component securities” in the index, as defined in subparagraph (B)), comprises no more than 30 percent of the index’s weighting; and
- (iv) each component security in the index is registered pursuant to section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l).

(B) AFFILIATED COMPONENT SECURITIES.—For purposes of determining whether component securities in the index are “affiliated component securities” in the index, entities issuing component securities shall be deemed to be affiliated if 30 percent or more of each entity is under common control or ownership.

**Appendix B****3. Broad-Based Foreign Debt Security Index:**

Foreign debt security markets, like domestic debt security markets, are not accommodated by the current equity-based index definition in the CEA. Accordingly, the proposed definition for a broad-based foreign debt security index generally tracks the requirements of the proposed broad-based domestic debt security definition, with two exceptions:

- the inclusion of municipal securities in the proposed broad-based debt security index definition is not applicable to the broad-based foreign debt security index definition.
- the proposed broad-based foreign debt security index definition similarly provides for nine unaffiliated component securities, but it excludes certain foreign government securities from this requirement. The rationale for this exclusion is that certain foreign government debt is exempted from the SEC's registration requirements for the purpose of trading futures contracts on those securities in the United States. *See* Rule 3a12-8 under the Securities Exchange Act of 1934, 17 C.F.R. 240.3a12-8. Since such exempted securities individually could be the subject of a futures contract, there is no need for an index to require a minimum number of such securities.

**Statutory Language:** Section 1a of the CEA (7 U.S.C. 1a) is amended by inserting at the appropriate places the following:

( ) BROAD-BASED FOREIGN DEBT SECURITY INDEX.—

(A) IN GENERAL.—The term “broad-based foreign debt security index” means any index in which:

- (i) the component securities in the index are debt obligations, as defined in section 2(a)(1) of the Securities Act of 1933 and in section 3(a)(1) of the Securities Exchange Act of 1934, issued by entities organized pursuant to the laws of a country other than the United States;
- (ii) the component securities in the index are issued by at least nine unaffiliated entities; and
- (iii) the debt of a single entity issuing component securities in the index (or the aggregate of “affiliated component securities” in the index, as defined in subparagraph (B)), comprises no more than 30 percent of the index's weighting.

(B) AFFILIATED COMPONENT SECURITIES.—For purposes of determining whether component securities in the index are “affiliated component securities” in the index, entities issuing component securities shall be deemed to be affiliated if 30 percent or more of each entity is under common control or ownership.

(C) FOREIGN GOVERNMENT DEBT SECURITIES.—Foreign government debt securities designated as exempt securities pursuant to Rule 3a12-8 under the Securities Exchange Act of 1934, 17 C.F.R. 240.3a12-8, may be included in a security index defined in this paragraph, but shall not be required to comply with any of the requirements of subparagraph (A); futures and options on individual exempt foreign government debt securities shall be specifically permitted under this Act.

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### **4. Broad-Based Security Index:**

The CFMA amended the CEA and the Securities Exchange Act of 1934 to provide that the agencies may jointly establish regulations regarding indexes that are not “narrow-based” for futures on indexes that are traded on or subject to the rules of a board of trade. CEA Section 1a(25)(B)(vi); Exchange Act Section 3a(55)(C)(vi). To date, the agencies have not developed “broad-based security index” definitions. To provide legal certainty to products and market participants in this area, the Commission believes it would be helpful to provide a general broad-based security index definition to clarify what products fall within the exclusive jurisdiction of the CFTC. The proposed definition includes references to the foreign broad-based security index definition, the debt security index definition, and the foreign debt security index definition, as discussed above. In addition, the proposed definition includes references to existing sections of Section 1a(25)—the statutory definitions of narrow-based and non-narrow-based indexes. Lastly, the CFTC has proposed a conforming amendment that would clarify the exclusive jurisdiction of the Commission over futures on broad-based security indexes.

**Statutory Language:** Section 1a of the CEA (7 U.S.C. 1a) is amended by inserting at the appropriate places the following:

( ) BROAD-BASED SECURITY INDEX.—

- (A) IN GENERAL.—The term “broad-based security index” means an index that—
- (i) is a broad based foreign security index, a broad-based debt security index, or a broad-based foreign debt security index as defined in sections 1a( ), ( ), or ( );
  - (ii) is not a narrow-based security index as defined in section 1a(25)(A);
  - (iii) meets the requirements of sections 1a(25)(B)(i), (ii), or (iii); or
  - (iv) meets the requirements of Commission rules, regulations or orders promulgated or issued in accordance with the provisions of section 1a(25)(B)(v).
- (B) COMMISSION DETERMINATION.—The Commission may, by rule, regulation or order, include within the term “broad-based security index” any index or group of indexes that it determines meets the requirements of sections 2(a)(1)(C)(ii)(I) and (II).

\* \* \* \*

Conforming Statutory Language:

Section 2(a)(1)(C) of the CEA (7 U.S.C. 2(a)(1)(C)) is amended in subsection (ii) by: 1) inserting “that is a broad-based security index, including any broad-based foreign security index, broad-based debt security index, or broad-based foreign debt security index” after “(or any interest therein or based upon the value thereof)”; and 2) in subclause (III), deleting “shall not constitute a narrow-based security index” and inserting in its place “shall constitute a broad-based security index.” As amended, subsection (ii) would read as follows:

- (ii) This chapter shall apply to and the Commission shall have exclusive jurisdiction with respect to accounts, agreements (including any transaction which is of the character of, is commonly known to the trade as, an “option,” “privilege,” “indemnity,” “bid,” “offer,” “put,” “call,” “advance guaranty,” or “decline guaranty”) and transactions involving, and may designate a board of trade as a contract market in,

**Appendix B**

or register a derivatives transaction execution facility that trades or executes, contracts of sale (or options on such contracts) for future delivery, of a group or index of securities (or any interest therein or based upon the value thereof) that is a broad-based security index, including any broad-based foreign security index, broad-based debt security index, or broad-based foreign debt security index: *Provided, however,* That no board of trade shall be designated as a contract market with respect to any such contracts of sale (or options on such contracts) for future delivery, and no derivatives transaction execution facility shall trade or execute such contracts of sale (or options on such contracts) for future delivery unless the board of trade or the derivatives transaction execution facility, and the applicable contract, meet the following minimum requirements:

(I) Settlement of or delivery on such contract (or option on such contract) shall be effected in cash or by means other than the transfer or receipt of any security, except an exempted security under section 3 of the Securities Act of 1933 or section 3(a)(12) of the Securities Exchange Act of 1934 as in effect on the date of enactment of the Futures Trading Act of 1982 (other than any municipal security, as defined in section 3(a)(29) of the Securities Exchange Act of 1934 on the date of enactment of the Futures Trading Act of 1982);

(II) Trading in such contract (or option on such contract) shall not be readily susceptible to manipulation of the price of such contract (or option on such contract), nor to causing or being used in the manipulation of the price of any underlying security, option on such security or option on a group or index including such securities; and

(III) Such group or index of securities shall constitute a broad-based security index.

## ANALYSIS OF FOREIGN STOCK INDEXES USING PROPOSED PATH C

	Foreign Index	Number of Stocks In Index (1/28/2005)	Largest Stock No larger than 30% of Index (1/28/2005)	Largest 5 stocks no larger than 80% of Index (1/28/2005)	Index Currency Adjusted Market Capitalization (USD) (1/28/2005)	At Least 50% of Country Mkt. Cap (1/28/2004)	Futures Exchange
Switzerland	1 SWISS PERFORMANCE INDEX (SPI) TOTAL RETURN	229	17.66	66.03	\$ 788,128,028,545	Yes	
Switzerland	2 SPI PRICE RETURN	229	17.66	66.03	\$ 788,128,028,545	Yes	
Switzerland	3 IBS 100	100	18.05	67.35	\$ 765,828,787,030	Yes	
Switzerland	4 SPI MID & LARGE COMPANIES	88	18.07	67.57	\$ 759,318,466,576	Yes	
Switzerland	5 SWISS MARKET	27	19.87	74.32	\$ 670,231,688,082	Yes	Eurex
Switzerland	6 SPI LARGE COMPANIES	17	20.98	78.44	\$ 626,664,755,175	Yes	
Belgium	7 BRUSSELS STOCK EXCHANGE (BEL20)	19	16.22	69.70	\$ 206,688,634,882	Yes	Eurotext Brussels
Russia	8 SSPRUX COMPOSITE	44	21.51	70.15	\$ 199,368,355,370	Yes	
Denmark	9 KFX COPENHAGEN SHARE	20	16.63	68.33	\$ 151,634,273,272	Yes	Copenhagen Stock Exchange
Norway	10 ODX STOCK	25	18.06	65.27	\$ 141,254,702,527	Yes	Oslo Stock Exchange
Greece	11 FTSE/ASE 20	20	19.50	64.31	\$ 91,541,310,185	Yes	Athens Derivatives Exchange
Austria	12 AUSTRIAN TRADED ATX	22	18.76	64.55	\$ 86,664,709,089	Yes	Wiener Borse
Portugal	13 PORTUGAL PSI-20	20	20.10	73.79	\$ 55,642,035,781	Yes	EuroNext Lisbon
Poland	14 WSE WIG 20	20	15.36	61.77	\$ 46,003,907,221	Yes	Warsaw Stock Exchange
Qatar	15 DOHA SECURITIES MARKET	20	19.01	65.19	\$ 45,809,860,428	Yes	
Australia	16 S&P/ASX 300 FINANCIAL EX. PROPERTY TRUST	36	17.72	66.73	\$ 222,228,103,025	No	
Australia	17 S&P/ASX 200 FINANCIAL	31	17.76	66.87	\$ 221,602,450,402	No	
Ireland	18 IRISH OVERALL	50	17.96	61.83	\$ 104,004,854,693	No	
Japan	19 KYOTO ECONOMIC DAILY	64	16.31	63.15	\$ 99,073,775,892	No	Helsinki Exchange
Finland	20 HEXTEH	10	24.02	78.43	\$ 59,916,188,725	No	Hong Kong Futures Exchange
Hong Kong	21 HANG SENG CHINA ENTERPRISES	37	25.50	62.28	\$ 98,861,209,997	No	
Egypt	22 EGYPT HERMES	32	29.22	76.38	\$ 35,819,217,688	Yes	
Chile	23 CHILE INTER-10	10	22.55	73.32	\$ 31,454,739,333	No	
Greece	24 ATHENS STOCK EXCHANGE INDUSTRIES PRICE	52	29.96	67.96	\$ 22,925,960,650	No	
Argentina	25 ARGENTINA Merval	11	23.22	73.02	\$ 22,419,073,555	No	
Philippines	26 PHILIPPINES COMMERCIAL	51	25.84	70.84	\$ 19,315,280,537	Yes	
Poland	27 WSE TECHWIG	32	17.26	62.11	\$ 12,079,861,033	No	Warsaw Stock Exchange
Oman	28 MUSCAT SECURITIES MARKET (MSM30)	30	26.03	62.54	\$ 7,163,773,235	Yes	
Greece	29 ATHENS STOCK EXCHANGE GENERAL (MIDCAP)	40	23.36	62.73	\$ 5,463,561,850	No	
Venezuela	30 VENEZUELA STOCK MARKET	16	30.60	74.33	\$ 3,961,048,690	Yes	

\* Stock indexes above the bold red line are broad based under the proposed Path C requirements but are narrow based under 1a(25) of the CEA.

\*\* Stock indexes highlighted in blue are broad based under the proposed Path C requirements and currently underlie futures contracts on foreign boards of trade.

\*\*\* Stock indexes below the bold red line are narrow based under the proposed Path C requirements and under 1a(25) of the CEA. Three of those indexes currently underlie futures contracts listed on foreign boards of trade.

\*\*\*\* Country market capitalization data is as of December 31, 2004.

\*\*\*\*\* Sources: Bloomberg Professional Services, The Handbook of World Stock, Derivative & Commodity Exchanges 2005.

**PREPARED STATEMENT OF PATRICK M. PARKINSON**

DEPUTY DIRECTOR, DIVISION OF RESEARCH AND STATISTICS  
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

SEPTEMBER 8, 2005

Chairman Shelby, Senator Sarbanes, and Members of the Committee, thank you for the opportunity to testify on the Commodity Futures Modernization Act of 2000 (CFMA) and on regulatory issues that have arisen in the context of the reauthorization of the Commodity Futures Trading Commission (CFTC). The Chairman's invitation letter requested that the testimony and written statement provide an overall evaluation of the CFMA and address three specific regulatory issues: (1) legislative measures to address fraud in certain retail foreign currency transactions; (2) portfolio margining for security futures products; and (3) futures on narrow-based securities indexes.

**Overall Evaluation of the CFMA**

The Federal Reserve Board believes that the CFMA has unquestionably been a successful piece of legislation. Most important, as recommended by the President's Working Group on Financial Markets in its 1999 report, it excluded transactions between institutions and other eligible counterparties in over-the-counter financial derivatives and foreign currency from regulation under the Commodity Exchange Act (CEA).<sup>1</sup> As the Working Group argued, regulation of such transactions under the CEA was unnecessary to achieve the act's principal objectives of deterring market manipulation and protecting investors. Such transactions are not readily susceptible to manipulation and eligible counterparties can and should be expected to protect themselves against fraud and counterparty credit losses. Exclusion of these transactions resolved long-standing concerns that a court might find that the CEA applied to these transactions, thereby making them legally unenforceable. At the same time, the CFMA modernized the regulation of U.S. futures exchanges, replacing a one-size-fits-all approach to regulation with an approach that recognizes that the regulatory regime necessary and appropriate to achieve the objectives of the CEA depends on the nature of the underlying assets traded and the capabilities of market participants. Together, these provisions of the CFMA have made our financial system and our economy more flexible and resilient by facilitating the transfer and dispersion of risk. Consequently, the Board believes that major amendments to the regulatory framework established by the CFMA are unnecessary and unwise.

Nonetheless, the Board supports some targeted amendments to the CEA to address persistent problems with fraud in retail foreign currency transactions and to facilitate the trading of security futures products and futures on security indexes.

**Fraud in Retail Foreign Currency Transactions**

In its 1999 report, the President's Working Group concluded that, to address problems associated with foreign currency "bucket shops," the CEA should be applied to transactions in foreign currency futures if they are entered into between a retail customer (an individual or business that does not meet the definition of an eligible counterparty) and an entity that is neither federally regulated nor affiliated with a federally regulated entity. The CFMA included provisions that were largely consistent with the Working Group's recommendation.

The CFMA has allowed the CFTC to take numerous enforcement actions against retail foreign currency fraud. However, the CFTC has continued to encounter certain difficulties in this area. These difficulties have stemmed from two sources. First, the CFTC's authority is limited to foreign currency futures, and some entities have fraudulently marketed contracts that, although similar to futures, have characteristics that have led some courts to conclude that they are not futures and that the CFTC has no jurisdiction. Second, some perpetrators of fraud have taken advantage of the CFMA's exclusion from CFTC jurisdiction of retail foreign currency futures offered by futures commission merchants (FCM's) and their affiliates. These perpetrators have set up thinly capitalized FCM's and used affiliates of those FCM's or unregulated unaffiliated entities to fraudulently solicit retail customers.

The Board believes that fraud undermines the functioning of financial markets and that some governmental entity must have the authority to protect retail investors in foreign currencies by taking enforcement action against entities that are defrauding them. Although the States have an important role to play in combating

<sup>1</sup> President's Working Group on Financial Markets (1999), *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (Washington, DC: November). [www.ustreas.gov/press/releases/reports/otcact.pdf](http://www.ustreas.gov/press/releases/reports/otcact.pdf).

fraud, the President's Working Group concluded in 1999 that the CFTC is the appropriate Federal regulator and should have clear authority to pursue retail fraud by foreign currency bucket shops. Consequently, the Board supports targeted amendments to the CEA that address the specific difficulties that the CFTC has encountered in taking enforcement action in this area. It is critical that those amendments be carefully crafted to avoid creating legal or regulatory uncertainty for legitimate businesses providing foreign exchange services to retail clients. The Board would be opposed to extending any new CFTC authority to retail transactions in other commodities without further careful consideration and demonstrated need. Provisions crafted to avoid creating uncertainty for legitimate foreign currency businesses are unlikely to provide the same protection to a much wider range of businesses.

#### **Portfolio Margining for Security Futures**

The CFMA gave the Board authority to prescribe regulations establishing initial and maintenance margins for security futures products or to delegate that authority jointly to the CFTC and the Securities and Exchange Commission (SEC). The Board delegated its authority to the commissions in a letter dated March 6, 2001. The letter indicated that the Board concluded that delegation is appropriate because it believes that the most important function of margin regulations is prudential—that is, to protect margin lenders from credit losses. In the case of security futures, the lenders are broker-dealers and FCM's, and the commissions are responsible for all other aspects of prudential regulation of those firms.

Portfolio margining is a method for setting margin requirements that evaluates positions as a group or portfolio and takes into account the potential for losses on some positions to be offset by gains on others. Specifically, the margin requirement for a portfolio is typically set equal to an estimate of the largest possible decline in the net value of the portfolio that could occur under assumed changes in market conditions. Portfolio margining is an alternative to "strategy-based" margining. With strategy-based margining, the potential for gains on one position in a portfolio to offset losses on another position is taken into account only if the portfolio implements one of a designated set of recognized trading strategies. The margin requirements for recognized strategies are set out in the rules of self-regulatory organizations. Each strategy is viewed in isolation; the remainder of the portfolio and other strategies are not taken into account.

The Board has supported the use of portfolio margining for some time. For example, in 1998 the Board amended Regulation T to allow securities exchanges to develop portfolio margining as an alternative to strategy-based margining, subject to SEC approval. In its 2001 letter delegating its authority over margins for security futures products jointly to the CFTC and the SEC, the Board requested that the commissions, either jointly or individually, report to the Board annually on their experience exercising the delegated authority and to include in those reports an assessment of progress toward portfolio margining for securities futures products. The Board continues to believe that portfolio margining is both more risk-sensitive and more efficient than strategy-based margining.

Unfortunately, to date no progress has been made toward portfolio margining of security futures products. Because the CFMA stipulates that margin requirements for security futures products must be consistent with margin requirements on comparable securities options, progress for security futures requires progress on options. Although margin requirements for options have for many years been portfolio-based at the clearing level, customer margins were until very recently strictly strategy-based. However, in July the SEC approved rule changes that create a 2-year pilot program that would permit portfolio margining of options and futures positions in broad-based stock indexes held by customers with a minimum account equity of \$5 million or more. If this pilot program were adopted as a margining system available to all customers for a broader range of products, significant progress toward portfolio margining of securities futures products would become possible.

The Commodity Exchange Reauthorization Act of 2005, which the Senate Agriculture Committee approved in July, proposes to make progress on portfolio margining (1) by eliminating the need for margins required on security futures to be consistent with those required on comparable options and (2) by substituting CFTC oversight of security futures margins for joint regulation by the CFTC and the SEC under delegation from the Board. This approach would be a marked departure from the regulatory regime for security futures that was established by the CFMA. The Board believes that it is appropriate for the Congress to spur progress toward portfolio margining for security futures but that this can be accomplished without changing so fundamentally the regulatory regime for security futures margins. For example, the Congress could spur more rapid progress toward portfolio margining

for both security futures products and options by requiring the commissions to jointly adopt regulations permitting the use of risk-based portfolio margin requirements for security futures products within a short but reasonable time period and requiring the SEC to approve risk-based portfolio margin requirements for options within the same period.

#### **Futures on Narrow-Based Securities Indexes**

The CFMA distinguished between futures on broad-based security indexes, which are subject to the exclusive jurisdiction of the CFTC, and futures on narrow-based securities indexes, which are considered security futures products and, as such, are subject to joint CFTC and SEC jurisdiction. Some futures exchanges argue that the definition of a narrow-based index in the CFMA was drafted with reference to the U.S. equities markets and that, in any event, the definition unnecessarily restricts the trading of futures on indexes of U.S. debt obligations and foreign securities.

The 2005 Reauthorization Act would address those concerns by requiring the CFTC and the SEC to jointly promulgate a revised definition of a narrow-based securities index that would better reflect capitalization, trading patterns, and trade reporting in the underlying markets. Such a definition would permit futures on indexes of U.S. debt obligations and foreign securities to trade as broad-based indexes if the indexes are not readily susceptible to manipulation.

Although the Board does not have a strong interest in this issue, it favors taking another look at the appropriateness of applying the existing definition of a narrow-based index to indexes of foreign securities. First, for many years several futures on foreign equity indexes have been trading abroad and have been offered to customers in the United States. Although these indexes would be considered narrow-based indexes under the existing definition, we see no evidence that these indexes have been susceptible to manipulation. Second, the provision in the 2005 Reauthorization Act can be seen as simply reiterating an existing requirement in the CFMA that the CFTC and the SEC jointly adopt rules that define narrow-based indexes based on foreign securities.

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### **PREPARED STATEMENT OF CHARLES P. CAREY**

CHAIRMAN OF THE BOARD, CHICAGO BOARD OF TRADE

SEPTEMBER 8, 2005

Mr. Chairman and Members of the Committee, thank you for the opportunity to submit this written testimony on behalf of the Chicago Board of Trade (CBOT) for the record and for the consideration of the Committee. The CBOT also thanks and congratulates the Congress for the passage in 2000 of the Commodity Futures Modernization Act (CFMA). The CFMA provided for increased competition and legal certainty in the derivatives industry and reduced many unnecessary regulatory burdens that served only to increase costs for the investing and hedging participants in U.S. financial markets. Some of the goals and promises of the CFMA have not been fully realized, however. Dual regulation and inefficient margining have contributed to an environment that has inhibited the development of a robust single stock futures industry. Regulatory confusion may be keeping other innovations from the market. And an unfortunate court decision has been issued which, if not overturned, raises the specter of increased fraud.

#### **Fraud by Unregistered Persons Offering Leveraged Futures “Look-a-Like” Contracts Should be Addressed**

The influential Seventh Circuit Court of Appeals in Chicago has rendered an opinion which essentially does away with previously settled law setting out determining characteristics of a futures contract. *Commodity Futures Trading Commission v. Zelener* 373 F.3d. 861 (7th Cir. 2004). This decision provides a road map for unregulated commodity transactions that can be used to defraud those least able to defend against it.

The CFMA excluded from the coverage of the Act certain over-the-counter transactions that involve highly capitalized, sophisticated persons—defined in the CFMA as “eligible contract participants.” These persons were deemed by the Congress to possess, or at least to be able to obtain, the acumen or expertise to engage in margined or leveraged transactions in commodities without the protection of Commission regulation. Congress continued to believe that persons who did not meet the criteria for becoming eligible contract participants still needed the protection of Federal regulation by the Commodity Futures Trading Commission (CFTC) if they dealt in commodity futures.

When the CFMA was enacted and for 4 years after that, there was relative certainty as to what constituted a futures contract. For 22 years, the decision in *CFTC v. Co Petro Marketing Group, Inc.*, 680 F.2d 573, 577 (9th Cir.1982) provided the means for the Commission, the industry, and the courts to determine whether a financial transaction that could be used for leveraged or margined speculation on the prices of commodities was a futures contract. Using a “totality of the circumstances” test, the Commission and the courts could effectively deal with persons who offered speculative contracts involving commodities without proper registration.

Registration and the capital requirements found in Commission regulations acted to ensure persons who offered futures contracts to the public had a large enough financial stake that they would not simply close up shop and disappear with their customers’ money. Commission regulation and capital requirements essentially provided a credit and background check on such firms, which individuals and smaller entities, that is, persons who are not eligible contract participants, lack the resources or ability to carry out for themselves.

When fraudulent dealings in commodities came to the attention of the Commission, typically the perpetrator was not a Commission registrant. The CFTC could immediately shut the operation down because the unregistered person was not permitted to offer or solicit orders for futures contracts because of the lack of registration. By moving quickly, and without first having to show all the requisites of fraud, the CFTC frequently could catch wrongdoers off guard and prevent them from hiding or otherwise further dissipating the assets of those who had been defrauded.

These Federal protections for persons who are not eligible contract participants, along with the ability of the Commission to bring enforcement actions in appropriate cases, are no longer available against those who commit fraud using the form contract deemed not to be a futures contract in *Zelener*. Persons who are not eligible contract participants, that is, those who Congress believed in 2000 still needed the protection of Federal regulatory jurisdiction, are now protected only by the threat of after-the-fact legal actions by local prosecutors under the laws of the individual States.

The fundamental weakness of this approach was clearly demonstrated in the early part of the 2000’s and lead to the enactment of the Federal securities laws. In that era, persons who defrauded others in connection with the sale of securities were relatively safe from prosecution if they took care to cheat only persons located in another State. Local prosecutors in the State in which the criminal was located may have had little incentive to use their resources if the bulk of the victims were in other States, having more immediate and pressing needs in other areas; and prosecutors in States where the victims were located did not have jurisdiction over the person committing the fraud from another State. The Congress, according to Stephen M. Cutler, a former Director of Enforcement for the Securities and Exchange Commission, addressed this problem by making investor protection one of the goals of Federal securities legislation in 1933 and 1934. Congress, recognizing “the ability of scammers to ‘take advantage of State boundaries,’” saw fit to establish the Securities and Exchange Commission as a Federal presence to deal with the interstate nature of securities fraud.<sup>1</sup>

To further quote Mr. Cutler, but in the similar context of commodity fraud, “these concerns have a surprisingly contemporary sound to them.” Current day wrongdoers use telephone, internet, and television appeals to showcase their fraudulent “pitches” involving heating oil, gold, and other commodities. The National Futures Association and the Commodity Futures Trading Commission try to monitor these websites and infomercials, but the advent of the *Zelener* opinion may leave them impotent in the face of flagrant fraud.

The *Zelener* case is not about only foreign exchange products. The contract the *Zelener* Court found to be outside the jurisdiction of the CFTC may just as easily be utilized by scammers to induce the unsuspecting to invest in other commodities. Unless checked by an amendment to the CEA overturning the *Zelener* opinion, such fraudulent operators could cause a scandal similar to those involving options on sugar and other commodities in the mid-1970’s. Such a scandal could, as then, reflect adversely on the legitimate financial services and derivatives industry here in the United States.

<sup>1</sup> See, Remarks of Stephen M. Cutler, Director, Division of Enforcement, Securities and Exchange Commission, at Washington University School of Law, February 21, 2003, on SEC website found at [http://www.sec.gov/news/speech/spch022103smc.htm#footnote\\_5](http://www.sec.gov/news/speech/spch022103smc.htm#footnote_5), citing Hearing on the Federal Securities Act, 73rd Congress, First Session, A Study of the Economic and Legal Aspects of the Proposed Federal Securities Act (submitted for the record by the Department of Commerce) pp. 99, 101.

The Chicago Board of Trade hopes that Congress will enact an amendment giving the CFTC the power to shut these fraudulent operators down by showing that they are dealing in futures contracts without the required registration, before this activity results in the loss of hard-earned savings of citizens. We favor an amendment that would cover all margined or leveraged speculative commodities transactions entered into with persons who are not eligible contract participants. Merely providing enhanced antifraud authority that can be used only after a fraud has been foisted on the public is insufficient to effectively address the problem.

Some have questioned whether anything at all should be done, raising the possibility that someone's legitimate business may be somehow affected. A properly drawn amendment that restricts only those who deal with persons who are not eligible contract participants, along with the forward exclusion, the Treasury Amendment and the other provisions enacted as part of the CFMA, should not adversely impact the operations of any legitimate person or firm. Indeed, the industry carried out its business for years when the *Co Petro* standard was in place, including the 4 years between the passage of the CFMA and the issuance of the *Zelener* opinion, and a return to the regulatory landscape of that period should not further restrict any legitimate firm. To the extent, however, that persons may believe that proposed language may infringe on their legitimate operations, we would hope that they would provide specific examples so that language can be crafted to alleviate those concerns while giving the CFTC the necessary tools to protect the investing public.

#### **Dual Regulation Poses Barriers to Innovation**

The CFMA provided much-needed regulatory relief to entities regulated by the CFTC and granted the Commission flexibility to deal with new ideas and technological advances, while at the same time retaining concepts of customer protection that are essential to our industry. In addition, the CFMA brought legal certainty to many products either by removing them from Commission jurisdiction or by establishing standards and procedures by which products can be and remain exempt from further CFTC regulation. The CFMA also allowed for the trading of security futures products for the first time. This legislation and its implementation by the Commission have seen many successes. While the financial services industry has benefited greatly from the reforms of the CFMA, the goal of the Congress of reducing regulatory barriers to innovation has not been achieved in at least two areas, however.

First, the CBOT asks that the Congress consider clarifying that the definition of narrow-based security indexes does not include indexes on fixed income securities, corporate bonds, and other nonequity securities. The present definition creates a series of tests to distinguish narrow-based indexes from broad-based indexes. Unfortunately, these tests are only workable for indexes on U.S. equity securities, and index products based on nonequity securities do not implicate the same issues. However, the possibility that the definition could be interpreted to cover nonequity products has hampered development of such products due to confusion as to what regulations may or may not apply.

To illustrate this point, the CBOT, and I am sure a number of other exchanges, have considered offering futures based on corporate bond indexes. While we do not believe such indexes were intended to be captured by the definition of narrow-based security indexes, current law is not clear on that point. Many such indexes, if the tests designed to distinguish broad- from narrow-based indexes were applied, would fall into the narrow-based index category. As such, futures on these indexes could then be assumed to be regulated as stock futures products, jointly by the CFTC and SEC. Given that corporate bonds are not subject to the same regulatory regime as equity securities, the underlying reason for applying these tests to equity security indexes does not exist for corporate bond indexes. We believe that futures contracts on these types of indexes—whether indexes of corporate bonds, municipal bonds, or other securities—should be regulated by the CFTC just as all other nonequity security futures and broad-based security index futures are regulated. Clarification of the definition is an important issue that deserves to be addressed at this time.

Another issue the CBOT hopes Congress will consider is the margining regime for stock futures products. The CFMA constituted both the Securities and Exchange Commission and the CFTC as regulators of stock futures products. This dual regulation of stock futures products has been challenging to date and the growth of single stock futures in the United States has been anemic, at best. The inability, at least to this point, of the SEC and the CFTC to afford rational regulatory treatment of margining for these products continues to stymie further development of stock futures and other needed products.

Historically, the power to set margins for futures products was reserved to the exchanges. Congress recognized that futures margins were performance bonds, post-

ed by both buyers and sellers of commodities for future delivery, to ensure the performance of obligations under the contract, especially if the price moved adversely to one's position. Because futures contracts were not assets, such as stocks, and because margins were not a credit function in the acquisition of an asset, exchanges typically set margin at levels designed to cover the risk of several days' price movement on a historical basis. The levels of margin, set as a dollar amount per contract rather than as a percentage of the price of the underlying product, could quickly be changed in the event of higher volatility in prices, in other words, increased risk. With the advent of more powerful data processing and sophisticated financial valuation models and techniques, this risk-based margining today can be applied more precisely to futures positions and even to whole portfolios, measuring the risk inherent in individual positions as affected by other positions within the same portfolio. Using risk-based margining across whole portfolios has provided participants in the financial markets with greater flexibility and efficiencies, while at the same time affording greater stability to the markets themselves.

The CBOT hopes Congress will facilitate the margining of stock futures as futures contracts, recognizing that the economic function of a futures contract is not to acquire ownership of the stock, but rather is to act as a hedging vehicle.

The Chicago Board of Trade, the oldest and one of the largest futures exchanges in the world, vigorously competes in the international marketplace. We ask the Congress, and this Committee, to remain cognizant of the continued need to reduce unnecessary regulatory complexities that tend to inhibit the ability of U.S. exchanges to compete effectively with their counterparts around the world. We also ask the Congress to give the CFTC the tools necessary to prevent peripheral scandals that have the potential of tarnishing the U.S. derivatives industry.

Once again, the CBOT thanks the Committee for this opportunity. If the Committee or Members have questions, the CBOT will be happy to provide answers and additional information.

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#### **PREPARED STATEMENT OF JOHN M. DAMGARD**

PRESIDENT, FUTURES INDUSTRY ASSOCIATION

SEPTEMBER 8, 2005

Chairman Shelby, Ranking Member Sarbanes, Members of the Committee, I am John Damgard, President of the Futures Industry Association (FIA). On behalf of FIA, I want to thank you for the opportunity to appear before you today. FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 40 of the largest futures brokerage firms, known as futures commission merchants (FCM's), in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. FIA estimates that its member firms serve as brokers for more than 90 percent of all customer transactions executed on United States futures exchanges.

In the last Reauthorization of the Commodity Futures Trading Commission (CFTC), this Committee played an important role in forging the landmark legislation known as the Commodity Futures Modernization Act of 2000 (CFMA). With the goal of promoting "responsible innovation and fair competition among boards of trade, other markets and market participants," the CFMA amended the Commodity Exchange Act (CEA) to:

- Assure legal certainty for over-the-counter derivatives;
- Remove the 20-year (supposedly temporary) prohibition on futures on individual securities and narrow-based securities index contracts through the joint regulation of these products by the CFTC and the Securities and Exchange Commission (SEC); and
- Provide a more flexible regulatory system for futures and options.

In any legislation of hundreds of pages, some provisions do not work out as expected. The CFMA is no exception. In a handful of areas, the provisions of the CFMA could use some improvement. FIA looks forward to working with this Committee again on that effort.

On the overriding issue of the CFTC's Reauthorization, FIA's position is unequivocal. FIA believes the CFTC is an excellent agency that discharges its statutory obligations efficiently and effectively. We look forward to a continuation of this tradition of excellence under the CFTC's new Chairman, Reuben Jeffrey. The CFTC deserves to be reauthorized.

FIA believes there are four primary areas that should be addressed in order to fulfill the promise of the CFMA: Off-exchange retail foreign currency (FX) transactions; security futures; SRO transparency and governance; and competition. Retail FX transactions have been the main focus of attention in the President's Working Group in recent weeks and the CFTC Reauthorization bill reported by the Senate Agriculture Committee, S.1566, contains specific proposals for dealing with retail FX transactions. Most of my remarks will therefore focus on that issue, followed by a general summary of FIA's positions in the other areas.

### Retail FX Transactions

As the Committee will recall, in 1997 the U.S. Supreme Court dismissed a CFTC fraud prosecution, ruling that the CEA's Treasury Amendment enacted in 1974 provided a "complete exclusion" from the CEA for any off-exchange FX transactions, including FX futures and options transactions with retail customers. *Dunn v. CFTC*, 519 U.S. 465, 476 (1997). Three years later, Congress reconsidered the Treasury Amendment and made certain modest modifications. The CFMA reaffirmed that the CEA does not apply generally to any FX futures or options transactions, with three exceptions: (1) futures contracts traded on an organized exchange; (2) currency options not traded on a securities exchange; and (3) some FX futures that are offered to retail customers, what the statute calls "noneligible contract participants."<sup>1</sup>

This last category—retail FX transactions—has been the focal point of most of the debate in this CFTC Reauthorization. Current law grants the CFTC full jurisdiction over retail FX futures unless the retail customer's counterparty qualifies in one of six different categories: banks, broker-dealers, FCM's, affiliates of broker-dealers or FCM's, insurance companies, financial holding companies, or investment bank holding companies. Retail FX futures entered into with five of these six categories of qualifying entities—including banks, broker-dealers, and their affiliates—continue to enjoy a complete exclusion from the CEA. The only exception is for retail FX futures where a registered FCM or its affiliate is the counterparty; then the transactions are subject to the CFTC's powers to enforce the antifraud and antimanipulation prohibitions of the CEA.

In recent years, some unsavory, sharp operators have been registering shell companies as FCM's, avoiding any real exchange-traded futures business, creating affiliates to enter into retail FX transactions with consumers and engaging in or promoting fraudulent sales practices in connection with retail FX futures contracts. The CFTC has brought many cases to shut down these schemes. Still more firms are engaging in this form of sales fraud.

The CFTC's enforcement efforts in this area have been substantial. The CFTC has won many cases and put many firms out of business. However, last year the CFTC did lose one of these cases when it failed to prove that the firm involved was selling a futures contract. This is the *Zelener* case.<sup>2</sup>

*Zelener* and the retail FX fraud problem have raised a series of issues that many believe should be addressed in this CFTC Reauthorization. Let me summarize those issues and FIA's positions.

#### *Broad Fix (All Commodities) or Narrow Fix (FX only)?*

Some believe that the *Zelener* decision, even though it arose in the context of a single retail FX fraud case, could lead to broader enforcement issues for the CFTC in areas beyond FX. They would argue that the *Zelener* decision shrank the legal definition of a futures contract and thereby shrank the CFTC's enforcement jurisdiction generally, allowing con artists in the agricultural, energy, or precious metals area to defraud customers and avoid CFTC policing by proving that their offerings were not futures contracts under the *Zelener* precedent.

FIA disagrees with those who seek a broad fix. Since 1922, the CFTC's jurisdiction has been limited wisely to futures and options contracts. In fact, Congress as recently as 1982 pruned back CFTC jurisdiction to avoid any possibility that it could spill over into commodity cash or forward markets that operate throughout our country, and are subject to the jurisdiction of other agencies, including law enforcement at the Federal, State, and local levels.<sup>3</sup> Expanding the CFTC's jurisdiction to

<sup>1</sup> Section 1a(12) of the CEA defines "eligible contract participant" to mean an individual with more than \$10 million in total assets or \$5 million if the individual retains a professional price risk manager.

<sup>2</sup> *CFTC v. Zelener*, 373 F.2d 861 (7th Cir. 2004).

<sup>3</sup> In 1982, Congress amended the definition of a commodity trading adviser. Prior to the 1982 Act, a commodity trading advisor was broadly defined to include any person who was engaged in the business of providing advice "as to the value of commodities," including cash and forward market transactions. As amended in 1982 Act, a commodity trading adviser is now defined as

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apply to any form of nonfutures contracts would have profound and, FIA believes, adverse implications for the CFTC's ability to discharge its oversight of futures and options exchange-trading, especially given the agency's structure and limited resources. Congress granted the CFTC exclusive jurisdiction over the futures and related options markets in order to make certain the CFTC would concentrate its efforts on those vital areas of our economy. Nothing should distract the CFTC from its core mission.

Overreacting to *Zelener* would also be particularly inappropriate since the *Zelener* court just applied the evidence before it to the traditional legal guidelines for determining whether a transaction is a futures contract, focusing on whether the parties had the right to and contemplated offset of the transaction, and therefore mimicked the offset properties of exchange-traded futures. The CFTC's inability to prove its case to one court is no reason to transform the agency into a national police force for consumer fraud committed in any transaction with a commodity theme. In this regard, FIA is pleased that the CFTC's legislative package and S.1566 as reported by the Senate Committee on Agriculture (even if adopted only as a "placeholder") do not support the broader "all commodity" fix.

That does not mean FIA supports a "do nothing" approach to the retail FX issues. Far from it. Certain adjustments to the CFMA's provisions would help the CFTC combat the fraud and abuse we have seen in retail FX transactions in recent years. The CFTC claims it would be easier for it to curb that activity if it did not have to prove that the perpetrators of fraud were offering a futures contract. Yet granting the CFTC powers over nonfutures transactions has historically had troubling implications. Those two differing views frame the next issue being debated.

#### *CFTC's Non-Futures FX Jurisdiction: General or Antifraud Only?*

Both the CFTC and the Senate Agricultural Committee have proposed granting the CFTC new general jurisdiction over retail FX *nonfutures* transactions. Their proposal would empower the CFTC to develop any regulations it sees fit for retail FX transactions that are leveraged, margined, or financed and not for commercial use or where the customer takes immediate ownership and possession of the currency involved. It is not clear why the CFTC needs such sweeping regulatory power over these transactions or what kind of regulatory structure the CFTC would set up for these transactions. But it would be expected that the CFTC would adopt an array of regulations for it to enforce or may even ban these products outright.<sup>4</sup>

Expanding the CFTC's general regulatory jurisdiction to nonfutures would not only drain the agency's limited resources, but would lead to unwarranted legal uncertainty of the kind the CFMA stamped out in 2000. Both the CFTC's proposal and S.1566 introduce jurisdictional concepts that will not promote legal certainty. Statutory trip-wires like "financed on a similar basis" or "immediate ownership and possession" leave room for reasonable differences of interpretation that could lead unsuspecting and legitimate enterprises to run afoul of CFTC regulation. Moreover, the emphasis on ownership or possession of FX suggests that CFTC jurisdiction might turn on some of the same definitional dividing lines that have bedeviled courts and even the agency itself for many years in the area of distinguishing futures from forward contracts. Compounding the unintended collateral implications of these ambiguities is that the CFTC-S.1566 proposal apparently would allow the CFTC to render "per se" illegal FX-related financing activities of legitimate financial institutions or others.

For many months, FIA has proposed a different approach. We believe the CFTC's enforcement arsenal should be enhanced so that the agency could pursue retail FX fraud cases against bucket shops and boiler rooms without having to prove that the applicable FX transaction was a futures contract. This proposal would be a targeted response to the real problem—retail FX sales abuses—without expanding the CFTC's general regulatory jurisdiction and mission beyond futures. Removing the

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any person providing advice "as to the value of or advisability of trading in any contract for futures delivery made on or subject to the rules of any contract market, any commodity option authorized under section 4c, or any leverage contract authorized under Section 19 of this Act." That is, a person is required to be registered as a commodity trading advisor only if that person is providing advice with respect to transactions that fall within the Commission's exclusive jurisdiction.

<sup>4</sup> FIA is concerned that granting the CFTC general nonfutures authority also will lead to considerable legal confusion. One part of the CFTC's proposal states, for example, that the CEA antifraud provisions apply to retail FX *futures* offered by certain FCM's and their affiliates, but not FCM's that also operate as broker-dealers. Another part of the CFTC's proposal would apply those same antifraud provisions to any retail FX transaction even if not futures and even if offered by FCM's that are also broker-dealers. This inconsistency illustrates the difficulty of trying to superimpose nonfutures onto the futures regulatory provisions.

shield of the “futures contract defense” from those who prey on unsuspecting FX customers should make the CFTC’s already impressive enforcement track record in this area, even more impressive. And by focusing the CFTC’s resources on bringing fraud cases for retail FX, rather than adopting regulations, the retail public can expect better protection and better sales practices.

FIA recognizes that allowing the CFTC to pursue nonfutures, off-exchange fraud cases would be a significant departure from the CEA’s regulatory scheme. We know that many have criticized us for not simply taking the position that sales fraud in connection with transactions that are not futures contracts should be of no more concern to the CFTC than sales fraud in connection with nonsecurities transactions is to the SEC. But, in our view, the CEA recognized that FX was a special commodity which Congress had treated with special provisions for many years. Moreover, the special nonfutures retail FX antifraud provision would not apply to any transactions where the counterparty was one of the six types of qualifying entities Congress recognized in 2000.<sup>5</sup> Thus, granting the CFTC special, limited, and targeted nonfutures antifraud authority over certain retail FX transactions that operate outside existing regulatory systems seemed like an appropriate compromise.

FIA also believes that certain important enhancements should be enacted for the retail FX *futures* transactions Congress permitted in the CFMA. Experience has shown that some of the CFMA’s provisions in this area need tightening. A discussion of these issues follows.

#### *Should Solicitors of Retail FX Futures be CFTC-Registered?*

The CFMA has been interpreted by the CFTC to preclude the registration of many of those who solicit retail FX futures contracts. Since the problem with retail FX transactions has been sales fraud, it makes sense to ensure that any person who solicits retail customer business meet traditional CFTC fitness standards.

FIA proposes that any person who participates in the solicitation or recommendation of any retail FX futures contract where an FCM or its affiliate is the counterparty must be both CFTC registered and a member of National Futures Association. That would mean that any employee of an FCM or its affiliate that solicits retail FX futures business must be CFTC-registered. It also means that independent firms that introduce retail FX futures customers to FCM’s or their affiliates must be CFTC-registered. The only exceptions from this requirement would be for the other qualifying entities (including broker-dealers as well as broker-dealers that are also FCM’s) and those who are already subject to Federal regulatory supervision (like investment advisers). In addition, any person soliciting a customer to buy a retail FX futures contract where the counterparty is *not* a qualifying entity (including where the counterparty is not an FCM or affiliate meeting the conditions set forth below) would be engaging in the illegal offer of an off-exchange futures contract under the CEA. That person would be subject to the full enforcement authority of the CFTC.

Right now, no member of the public can find out who is eligible to solicit retail FX futures business. As a result of this reform, both the CFTC and NFA would have a list of those firms and individuals that are qualified to sell retail FX futures under CFTC jurisdiction. Either the CFTC or NFA, or both, may make this list available to the public through their websites or public information efforts. This proposal therefore would provide greater transparency to the investing public.

#### *Should Shell FCM’s Be Qualifying Entities?*

No. The CFMA has been interpreted by the CFTC to allow firms to register as FCM’s even if the firm does not intend to engage in the business of being an FCM, brokering or clearing exchange-traded futures contracts for others. Those firms (or their affiliates) can then become the counterparties to retail FX futures contracts and enjoy the benefits of an exemption that Congress wrote for FCM’s that would be engaged in the exchange-traded futures business.

FIA believes that when Congress granted this exemption for registered FCM’s, Congress intended those FCM’s would be real futures brokers, not shells. To achieve that objective, FIA has proposed that any FCM qualifying for the exemption to serve as a counterparty for retail FX futures must be “substantially and primarily” engaged in the exchange-traded futures business. The CFTC will have discretion to define “substantially and primarily” in this context. Through this requirement, the

<sup>5</sup> Under our proposal, the CFTC would retain its existing authority to pursue antifraud and antimanipulation actions against FCM’s and their affiliates (unless the FCM is also a broker-dealer or other qualifying entity) in connection with retail FX futures where the FCM or affiliate is a counterparty.

shell FCM loophole should be ended. S. 1566 does not contain a similar limitation on registered FCM's acting as counterparties for retail FX transactions.

This new "substantially and primarily" requirement also should contribute materially to reducing many of the sales practice abuses experienced in recent years. Substantial FCM's who deal with the retail public everyday will not want to see their reputations tarnished by sales practice abuses committed in connection with retail FX futures to which those FCM's (or their affiliates) are the counterparties.

#### **Should FCM Affiliates Be Allowed to Continue to be Qualifying Entities?**

Yes. The CFMA treats affiliates of broker-dealers and FCM's equally. Both are allowed to serve as qualifying entities that may be counterparties to retail FX futures under Section 2(c)(2)(B) of the CEA. FIA understands that the CFTC may now be proposing to allow broker-dealer affiliates to continue to act as counterparties to retail FX transactions but would bar FCM affiliates from continuing to do so. FIA believes both broker-dealer affiliates and FCM affiliates should continue to be able to serve as qualifying entities under Section 2(c)(2)(B) of the CEA. No basis exists to treat affiliates of broker-dealers more favorably in this regard than the affiliates of FCM's, especially once the shell FCM loophole is plugged as we have recommended.

FIA also believes the FCM affiliate provisions in Section 2(c)(2)(B) should be improved in two important respects. First, FIA recommends that only affiliates of FCM's with at least \$20 million in net capital (or higher if the CFTC believes it to be appropriate) should be eligible to be qualifying entities. This will ensure as a practical matter that if an affiliate of an FCM faces financial difficulty in performing its counterparty role, its FCM will have the capacity to step in and cover those obligations in order to avoid the harm to its reputation from a default. Second, FIA recommends that in order for any FCM affiliate to qualify under Section 2(c)(2)(B), the FCM must undertake to comply with the CFTC regulatory requirements (recordkeeping and reporting) for material associated persons or the affiliate must be a material associated person (MAP) of the FCM. By this requirement, the CFTC will retain an important measure of oversight for the FCM affiliate serving as the counterparty to the retail FX transaction.<sup>6</sup>

In 2000, the CFMA authorized FCM affiliates to qualify as counterparties for retail FX transactions. Based on that authorization, some affiliates have engaged in this business without customer complaints for years. Congress should not over-react to the sales problems others have caused by insisting now that those affiliates must cease operations.

#### *Should the CEA Prohibit Principal to Principal Fraud?*

Section 2(c)(2)(C) of the CEA makes the general antifraud provision in Section 4b applicable to all retail FX futures where an FCM (that is not also a broker-dealer) or its affiliate is the counterparty. Section 4b, however, was enacted in 1936 in the context of FCM's acting as brokers for customers on futures exchanges and prohibited defrauding any one the FCM was acting "for or on behalf of" as an agent. Section 4b did not, however, cover fraud in connection with transactions where the FCM or its affiliate would act as a principal or counterparty to the transaction. Since the retail FX futures transactions authorized by the CFMA contemplate that FCM's would act as principals to those transactions, questions were raised whether the CFTC's antifraud jurisdiction actually applied to those retail FX futures.

Section 2 of S. 1566 contains an amendment to Section 4b of the CEA that would extend that antifraud prohibition to principal to principal fraud. FIA supports this amendment. It would strengthen the CFTC's enforcement efforts in the retail FX futures area by removing another possible defense to a CFTC fraud prosecution.

FIA understands that the President's Working Group has focused its deliberations on the retail FX issue and we have accordingly focused our testimony on those issues. In summary, FIA sees no need for either a broad, all-commodity response to *Zelener* or to grant the CFTC general jurisdiction over retail FX nonfutures. Instead, FIA recommends Congress amend the CFMA in the retail FX futures area by (1) prohibiting shell FCM's; (2) registering soliciting retail FX futures firms and individuals; (3) imposing at least a \$20 million net capital requirement on FCM's whose affiliates are acting as permissible counterparties; (4) requiring any qualifying affiliates to comply with CFTC MAP regulation; and (5) expanding the CEA

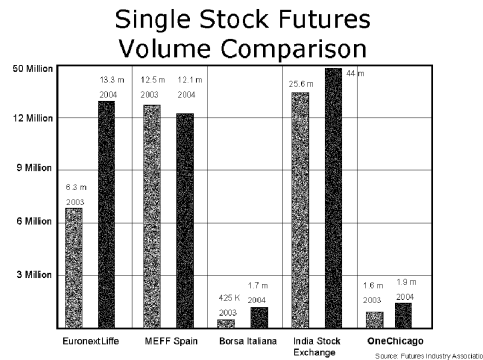
<sup>6</sup>Current law contains a perverse anomaly that this proposal will cure. Under current law, the affiliate of a modestly capitalized FCM would qualify as a MAP and be eligible as a qualifying entity. The affiliate of a substantially capitalized FCM might not qualify as a MAP since its operations would not be material to the overall financial picture of the FCM. In FIA's view, if the FCM undertakes in writing to the CFTC that its affiliate will comply with all MAP requirements even if the affiliate is not technically a MAP, that affiliate should be considered to be a qualifying entity so long as the FCM has at least \$20 million in net capital.

to cover principal to principal fraud. In addition, FIA continues to propose that Congress grant the CFTC special new enforcement powers to pursue fraud actions in connection with narrowly defined retail FX transactions even if not futures contracts. These changes will respond to the customer protection challenges of recent years without compromising the CFTC's overall mission or the CFMA's goal of legal certainty.<sup>7</sup>

### Security Futures Products

Since the enactment of the CFMA, FIA has worked diligently with the CFTC, the SEC and the exchange community to implement both the spirit and the letter of the provisions authorizing trading in security futures products. Although volume on these markets has not been as robust as we would like, we continue to believe that this is an important product that will grow over time. Last year, the only U.S. market for security futures—OneChicago—increased its annual trading volume by 19 percent from 1.6 million contracts in 2003 to 1.9 million in 2004.

In contrast, security futures are more popular in other countries. As the following chart shows, at the London based Euronext.Liffe exchange, 2004 single stock futures volume was up 114 percent over 2003 volume, with a total of 13.5 million contracts traded. And at Italy's Borsa Italiana, single stock futures volume rose more than 250 percent last year as it traded over 1.7 million contracts. At the Stock Exchange of India, 2004 single stock futures volume was up 72 percent to 44 million contracts. And finally, even at Spain's MEFF exchange, where single stock futures volume was basically flat, they were still able to trade 12.1 million contracts. As you can see, it is clear that at this time the security futures industry in the United States has not caught up with our competitors on foreign exchanges.



FIA supports action in three areas relating to security futures. In each area, legislation would not be needed if the CFTC and SEC adopted administrative solutions as contemplated by the CFMA. But that has not happened. Reluctantly, FIA believes Congress should take some action to make certain that the agencies address these three areas.

First, U.S. futures exchange representatives believe that U.S. security futures markets would grow if their portfolio margining systems for futures generally were made available to security futures trading. The U.S. futures exchanges and clearing firms are deservedly proud of their portfolio margining systems. These systems provide financial integrity for the futures markets while allowing for more efficient use of capital by traders and clearing firms. The CFTC and the SEC are empowered to allow portfolio margining systems to apply to U.S. security futures markets. Since those markets are struggling now to catch up with foreign competition, FIA would

<sup>7</sup>The goal of legal certainty is also threatened by Committee Reports that attempt to create legislative history for statutory provisions that do not exist. For example, the Report of the Senate Committee on Agriculture claims to make certain amendments to Section 2(c)(2)(C) of the CEA that are mere clarifications of existing law. S. Rep. No. 109-19, 109th Cong. 1st Sess. 8 (2005). But those "clarifications" create significant new legal obligations and causes of action not contained in the CFMA and not discussed in any Committee hearings or deliberations. In addition, the Committee Report attempts to graft onto provisions that confirm the CFTC's ability to pursue civil enforcement actions for violations of the criminal provisions of the CEA limitations in the CFMA's exclusions and exemptions that contradict the actual language Congress enacted to achieve the goal of legal certainty. *Id.* at 6. Any expansions or contractions of the CFTC's jurisdiction in this important area should come from provisions Congress actually enacts.

urge the agencies to allow existing futures clearing portfolio margining systems to be applied to security futures products as soon as practicable.

FIA understands that the options and cash markets in securities also would like to have the SEC approve futures-style portfolio margining for their market users. FIA supports these efforts as well, provided that nothing tips the competitive scales in favor of broker-dealers at the expense of FCM's. Perhaps the fledgling security futures markets can offer a pilot program for this concept while the SEC considers adapting that system to the options and cash markets. Or the new leadership at the SEC and the CFTC can agree to a reasonable and mutually acceptable timetable for implementing portfolio margining. This is not a matter of seeking competitive advantage for security futures; it is a matter of competitive viability for security futures in the United States.

Second, provisions of the CFMA combined with regulatory intransigence are creating a significant competitive disadvantage for U.S. investors and U.S. firms. The problem stems from the definition of a "narrow-based" securities index in the CFMA, its application to indexes on securities other than U.S. equity securities, and the regulatory consequences for futures trading on any index that falls within the "narrow-based" definition.

Prior to the CFMA, in fact since 1981, futures contracts had been trading on stock indexes which were generally considered to be broad-based. Those stock index futures were traded subject to the CFTC's exclusive jurisdiction. An index was considered to be broad-based if the index could not be used as a surrogate for an individual stock or a small group of stocks or to manipulate the underlying cash market price. Otherwise, the CFTC and the SEC were concerned that insider trading in the stock could take place outside the SEC's purview through trading in the stock index futures contract.

In deciding to lift the ban on single stock futures in the CFMA, Congress chose to set up a special regulatory regime for those new futures products subject to shared CFTC and SEC regulatory authority. At the same time, Congress decided that some existing stock indexes, and surely those to be developed, could not be considered to be broad-based, but could become the subject of futures trading under the same rules as single stock futures. Congress decided therefore to treat and regulate both single stock futures and "narrow-based" stock index futures as "security futures products" subject to CFTC and SEC jurisdiction.

For a stock index, therefore, the issue whether it is "narrow-based" or "broad-based" has important regulatory consequences under the CFMA. Broad-based indexes (those are that not narrow-based) may be traded under the traditional rules for futures trading subject to CFTC jurisdiction. Narrow-based indexes may be traded only as security futures subject to the special rules set out in the CFMA. And, as discussed more fully below, U.S. investors are banned from trading foreign security futures products, including foreign futures on narrow-based indexes.

In the CFMA, Congress defined through numerical criteria what indexes would be considered to be "narrow-based"—at least 9 securities, no single security more than 30 percent of the index value, no five securities more than 60 percent of the index value, and aggregate capitalization amounts for the lowest quartile of the index. These criteria were authored jointly by the CFTC and SEC. While those criteria were adopted with U.S. equity markets in mind, the CFMA literally applies those criteria to any "security" market—debt or equity, foreign or domestic. For that reason, the CFMA grants the CFTC and SEC joint power to adopt criteria for defining "narrow based" indexes for these other security markets. To date, that has not happened.

Instead, we understand that the SEC has taken the view that the CFMA's narrow-based criteria apply to all equity markets, not just those in the United States. That position leads to some unintended and unfathomable results. For example, one foreign stock index comprised of 229 stocks traded in Switzerland is considered "narrow-based" because it would not meet the criterion that no five stocks may comprise 60 percent of the value of the index. Indexes developed to reflect the value of equity markets in many other countries, including Japan, Greece, Australia, Portugal, Russia, Belgium, Denmark, and Norway also do not meet the rigid CFMA narrow-based index criteria.

As a result, no U.S. firm may offer, and no U.S. investors may buy or sell, foreign futures on these indexes since they are foreign security futures products (foreign futures contracts on a narrow-based index). This is the case even though in foreign jurisdictions trading in these stock index futures is treated like any other futures contract.

FIA understands the agencies' rationale for the CFMA's "narrow-based" criteria as applied to U.S. equity markets. But misapplying those criteria to foreign equity markets has disadvantaged U.S. investors and U.S. FCM's in a profoundly anti-

competitive manner. Congress should provide the agencies with direct guidance on this issue and make certain that the “narrow-based” criteria no longer operate as a competitive barrier for U.S. exchanges, firms, and investors.

Third, as mentioned above, U.S. institutional investors are being discriminated against today because they are barred from trading futures on individual securities and narrow-based security index futures contracts on a non-U.S. exchange. These instruments could be of significant value to customers for various purposes, including risk management and asset allocation. The best way to understand the issue is this. FIA has been told by investment managers of the pension funds for U.S. Government employees that the rate of return earned on the U.S. employees’ funds is often not as high as the rate of return earned on the pension funds of foreign government employees. The reason is that the investment manager may not use foreign security futures products to manage the U.S. employees’ funds, but may use those risk management tools for foreign government employees.

In the CFMA, Congress instructed the SEC and the CFTC “to the extent necessary and appropriate in the public interest, to promote fair competition, and consistent with promotion of market efficiency, innovation, and expansion of investment opportunities” to “issue such rules regulations or orders as may be appropriate to permit the offer and sale of a security futures product traded on or subject to the rules of a foreign board of trade to United States persons.” Consistent with this explicit Congressional direction, FIA had been assured that necessary rules or orders permitting the offer and sale of foreign security futures products to U.S. persons would be adopted contemporaneously with the rules authorizing security futures products on U.S. exchanges. However, the CFTC and SEC did not promulgate such rules.

The investment objectives of pension plans, investment companies, endowments, hedge funds, and other large money managers that FIA members serve have been restricted by the agencies’ failure to act. Those institutional customers are free to engage in transactions in the international securities markets with few regulatory limitations. These institutions also are authorized to enter into principal-to-principal derivatives transactions that replicate foreign security index contracts, but may be more difficult, and substantially more expensive, to effect than exchange-traded instruments. In these circumstances, no U.S. regulatory purpose is served by preventing U.S. institutional customers, in particular, from using foreign futures on narrow-based indexes or single securities, provided that a U.S. stock exchange is not the primary market for the securities underlying such security futures products.

Unfortunately, S. 1566 does not address this issue. We request that this Committee work with your counterparts on the Agriculture Committee and the new leaders at the CFTC and SEC to determine when action in this area may be forthcoming and to codify that timetable in legislation. If the agencies believe that they need additional statutory authority, they should so advise Congress so that appropriate amendments can be enacted this year.

#### **SRO Governance**

Like the SEC and the securities markets, SRO governance has been an issue under review at the CFTC for some time. In this regard, FIA supports the important role that the exchanges, clearing organizations and National Futures Association perform as self-regulatory organizations (SRO’s). Given their strong market knowledge and close proximity to the trading markets, they provide the best vantage point for addressing many of the futures markets’ oversight functions. However, to be fully effective, there must be an increased degree of public confidence in the integrity and objectivity of SRO’s.

The Commission, the SRO’s, and the derivatives industry generally must act to remove the real and perceived conflicts of interest and potential for anticompetitive conduct that are inherent in any self-regulatory structure, particularly when the exchange is operated on a for-profit basis and has issued stock to the public. Specific modifications to the SRO structure should increase its overall efficiency and effectiveness. For example, FIA believes that establishing a meaningful number of truly independent directors on SRO Boards is one of the most important reforms that could be considered. The FIA has filed extensive comments with the CFTC in this area containing many recommendations. We would be pleased to provide our comments to this Committee at your request.

A good illustration of our concern is the recently adopted U.S. Treasury futures position limits imposed by the Chicago Board of Trade (CBOT). The CBOT imposed these limits through a new procedure made available under the CFMA. It allows futures exchanges to self-certify that their rule changes are in compliance with the CEA and then place the rules into effect without obtaining CFTC approval. On many noncontroversial rule changes this kind of administrative efficiency may make

sense. In this case, however, the CBOT's rule changes had an impact on trading in futures contracts with open positions and may have caused some to enjoy trading gains and some to suffer trading losses. Many market participants have raised serious questions about the (unstated) purpose of the CBOT's rule change and the ability of the CBOT to enforce its rule as written. Weeks after the CBOT's actions had been implemented, the CBOT offered only a partial explanation for why it took the action it did and how it intended to enforce its rule change.

Whether the CBOT's actions were wise or precipitous is not the main issue for FIA. We believe the fairness and transparency of the exchange rule change and approval process is the issue. We fear some market participants lost confidence in the CBOT by virtue of its decisions both to change the rules of the game during the game and to offer no reason for doing so. FIA does not believe that any contract market should self-certify rules that change the trading terms and conditions for contracts that have already been listed and where traders have already established open positions. But surely no exchange should take such action without telling the public why it took the action and how it reached that decision.

FIA hopes that CFTC Chairman Jeffrey will take a fresh look at this area in the coming months and that no legislation will be needed to address these issues.

### **Fair Competition**

Promoting fair competition should be the goal of any sound regulatory program. Robust competition facilitates the ability of U.S. futures markets to serve the public interest. Competition leads to reduced costs, higher volumes, narrower spreads, and greater innovation.

Our strong support for the CFMA was based in substantial part on our belief that competition, rather than a prescriptive regulatory structure that established excessively high barriers to entry, would be the best regulator. We fully anticipated that the CFMA's regulatory reforms would encourage new entrants to apply for designation with the Commission as contract markets or clearing organizations. These new self-regulatory organizations would compete among themselves and with the existing exchanges for customer business based on products, quality of execution, and cost.

Unfortunately, since the CFMA was enacted very little direct competition among markets has occurred. Virtually all efforts at direct competition have been unsuccessful thus far. Even the largest derivatives exchange in the world (EUREX) has been unable to penetrate the market share of the Chicago Board of Trade in U.S. Treasury Note and Bond futures. Shortly after EUREX US indicated it was reassessing its operations, the CBOT announced a fee increase for all market participants, an apparent by-product of the absence of competition.

Some believe that unless or until Congress or the CFTC mandate multiple contract listings together with cooperative clearing arrangements the potential benefits of meaningful direct competition will never be realized. (That would mean, for example, that a "long" contract entered into on Exchange #1 could be offset by a mirror-image "short" contract on Exchange #2 through cooperative or common clearing, and vice versa.) As this Committee well knows, it makes sense to give customers the ability to choose their market and obtain the best price available for an offsetting trade, even if the market with the best price is not the market where the original position was established.<sup>8</sup> These are salutary goals we believe everyone should support in the interest of serving the customer and enhancing competition. Yet, established exchanges are reluctant to surrender their market advantages.

As noted above, the efforts of the challenger markets to date have done little more than chip away at the entrenched markets' dominance. We believe that further study by the CFTC of how to stimulate futures market competition would be appropriate now. With the benefit of that analysis, Congress may wish in the future to consider whether legislation in the direct competition area would help to realize fully the goals of the CFMA.

### **Conclusion**

FIA greatly appreciates the opportunity to present its views to the Committee. We look forward to answering any questions you may have and to working with the Committee on this year's CFTC Reauthorization legislation.

<sup>8</sup>This system also would encourage customers to enter into original positions on a challenger exchange when that exchange offers the customer the better price. The customer then could offset that same position on the dominant exchange.

Testimony of

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Chairman of Chicago Mercantile Exchange Holdings, Inc.

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Chairman Shelby, ranking member Sarbanes, ladies and gentlemen of the Committee, I am Terry Duffy, Chairman of Chicago Mercantile Exchange Holdings, Inc., which owns and operates the largest U.S. futures exchange, and by critical standards, the largest futures exchange in the world. This hearing provides the Committee an opportunity to consider whether the Commodity Futures Modernization Act of 2000 ("CFMA") has lived up to its promise and/or whether a few minor adjustments may be necessary to insure that this important, complex piece of legislation fulfills its promise.

I will first summarize the positive impact of CFMA on CME and then focus on CME's suggestions for extending the positive impact of CFMA. I will discuss the explosion of off-exchange retail futures fraud and the *Zelener* loophole. I will also offer two suggestions to require joint SEC—CFTC action to accomplish exactly what Congress expected them to finish long before now. By way of a preview, we have a clear, simple agenda: 1. Reverse the impact of the *Zelener* case and close the Treasury Amendment registration loop-hole; 2. Mandate that the SEC and CFTC define Broad Based Indexes; and 3. Mandate that the SEC and CFTC take joint action to provide risk based margining for security futures products. I am confident that our solutions cause no harm, competitive or otherwise to any customer, legitimate participant in the industry or to the marketplace itself. To the contrary, our proposal will enhance the competitiveness, usefulness and integrity of US futures markets.

#### I. OVERVIEW OF CFMA: HISTORIC AND SUCCESSFUL LEGISLATION

CME has proved itself to be the premier industry innovator in developing new products and trading opportunities. We supported CFMA's deregulation of over-the-counter derivatives and the reduction of barriers to entry for new exchanges. We accepted a program of enhanced competition in the financial services industry in return for elimination of prescriptive regulation and **freedom to innovate. And innovate we did**, predominantly in four areas: governance (including our role as a self-regulatory organization ("SRO")); expansion of market penetration; innovation in product offerings; and pursuit of a legitimate entrepreneurial business model that is premised on meeting customer needs.

CME gained the right to demutualize and implement the form of governance necessary to complete a successful initial public offering (IPO) and to run an effective, efficient SRO. CME expanded its markets and product offerings at an unprecedented clip. We offer clearing and execution services to other exchanges and the OTC market to take full advantage of the scalability of our technology and to reduce the costs for our customers and even our competitors. Of course we are a business and these activities also flow to our bottom line.

U.S. futures markets are substantially stronger and more vibrant today as the direct result of Congress's enactment of the CFMA and, equally importantly, the CFTC's judicious and deliberate implementation of those reforms. Innovation has been encouraged and made less costly and more rewarding. The time between conception of a new product or trading system and its implementation has gone from years to days. Today, the vast majority of CME's investment in innovation is for products rather than paperwork and regulatory review. Our customers applaud CME's aggressive response to the CFMA's incentives for innovation and competition as evidenced by their enthusiastic response to our slate of products and services.

By illustration I would point out the following:

- Continuing the trend since the CFMA's enactment in late 2000, CME's average daily volume in the second quarter of 2005 increased more than 33% over the comparable period in 2004.
- Electronic trading volume on CME® Globex® averaged 2.6 million contracts per day, representing 69% of total exchange volume in August 2005.
- CME's Eurodollar futures contract remains the benchmark interest rate product around the world. Average daily volume of CME Eurodollar futures on CME Globex in August exceeded 1.1 million contracts. This represented 81 percent of total CME Eurodollar volume in August compared with 63 percent in August 2004.
- CME's FX markets continued to grow in August as average daily volume totaled more than 285,000 contracts, representing notional value of \$41 billion per day and an increase of 68% from one year earlier. During August 2005, CME electronic foreign exchange products increased 101 percent from the same period one year ago to reach 240,000 contracts per day.
- Trading in CME E-mini™ equity index products averaged 1.1 million contracts per day in August, up 18 percent versus the same period last year.
- CME's commodity products also continue to trade well, with average daily volume in August at 42,000 contracts, up 20 percent from one year ago.

- Finally, the historic transaction processing agreement between CME and CBOT has delivered on its promises of efficiencies and cost savings to customers, setting new industry standards for responsiveness to customers and efficiency.

## II. CFMA HAS FOSTERED INNOVATION IN SELF-REGULATION

CME takes considerable pride in our status as the only demutualized and publicly-traded futures exchange in the United States. CME is currently the largest futures exchange in the United States and the largest derivatives clearing organization in the world. Moreover, our business has steadily migrated from the trading pits to our open access electronic trading platform---CME Globex. These changes have had a profound, positive impact on our financial performance, but as importantly on our customers' perception of our performance of our self regulatory responsibilities.

With our IPO, CME is now subjected to and complies with all the stringent corporate governance standards and listing requirements imposed by the New York Stock Exchange, public disclosure of all material aspects of its business, and continuous scrutiny from savvy analysts and institutional investors. In order to meet our obligations and to instill confidence in our shareholders, CME's Board of Directors has transitioned to one that is both fiercely independent of management and well beyond the control of floor brokers and traders.<sup>1</sup> CME was the pioneer in including non-exchange members in its disciplinary processes and in insuring that its important standing Board Committees were led by and included significant representation of non-industry directors. The charters of all of these committees, including the Market Regulatory Oversight Committee ("MROC") which is composed entirely of non-industry directors and is directly responsible for the independence of the SRO function, are found at CME's website.

On April 30, 2004, CME became the first futures exchange to appoint a Board-level committee devoted to self-regulatory oversight. CME's MROC is comprised solely of independent, non-industry directors. As set forth in its charter, the MROC is charged with the following responsibilities:

- to review the scope of and make recommendations with respect to the responsibilities, budget and staffing of the Market Regulation Department and the Audit Department so that each department is able to fulfill its self-regulatory responsibilities;
- to oversee the performance of the Market Regulation Department and Audit Department so that each department is able to implement its self-regulatory responsibilities independent of any improper interference or

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<sup>1</sup> We also believe that directors who are members or end-users of an exchange organization have an invaluable understanding of the business and can provide useful perspectives on significant risks and competitive advantages. Indeed, the inclusion of exchange members on CME's Board has been beneficial in transforming CME from a century-old mutual organization to a thriving publicly-traded company and from a largely floor-based open outcry business to one of the largest electronic trading platforms in the world.

conflict of interest that may arise as a result of a member of CME serving on the Board or participating in the implementation of CME's self-regulatory functions;

- to review the annual performance evaluations and compensation determinations and any termination decisions made by senior management of CME with respect to the Managing Director, Regulatory Affairs, and the Director, Audit Department, so that such determinations or decisions are not designed to influence improperly the independent exercise of their self-regulatory responsibilities;
- to review CME's compliance with its self-regulatory responsibilities as prescribed by statute and the rules and regulations promulgated thereunder; and
- to review changes (or proposed changes, as appropriate) to Exchange rules to the extent that such rules are likely to impact significantly the self-regulatory functions of the Exchange.

We believe that the newly empowered MROC represents an aggressive and appropriate step towards independence in self-regulation.

### **III. CFMA HAS FOSTERED PRODUCT AND MARKET INNOVATION**

We have all witnessed dramatic change in our industry during the last five years. CME has responded to these opportunities by successfully executing a growth strategy based on:

- Technology innovation;
- Continued product innovation;
- Expanding global distribution; and
- Leveraging the convergence of the cash, derivatives and over-the-counter (OTC) markets.

#### **Technology Innovation:**

In terms of technology innovation, we have redesigned our business model to leverage our electronic trading capability. A sign of our successful transformation is that five years ago CME had 125 people focused on technology. Today, we have over 500 talented technologists, reflecting our view of the future. CME Globex today significantly outperforms its competitors by facilitating trading around the world more than 23 hours a day, five days a week and with a 150 to 200 millisecond average turnaround time.

Technology innovation at CME has become equal in importance to product innovation. And our ability to innovate is multi-dimensional. It involves expanded user functionality and faster response times. It also involves increased reliability and the implementation of system features designed to enhance market integrity and protect customers from anomalous market conditions. Last January, we provided market users with the most sophisticated implied spreading functionality in the industry. As a result, CME Eurodollar futures on CME Globex went from 9.6 percent electronic in January 2004 to 81 percent in August 2005.

A year ago, we acquired innovative patent-pending technology that now provides market users with a sophisticated electronic solution for complex options combination trading. CME is committed to preserving and enhancing transparency and competition among market makers in electronic options markets. Transparency and price competition are the hallmarks of CME's successful market model.

Another measure of our ability to innovate with technology is something most people never see. Over the last five years, and due to the unique processing demands of our enormously successful E-mini™ contracts, CME has built an extensive and highly scalable set of platforms and infrastructure. We now process over 600,000 match transactions daily, more than any other exchange in our industry. Part of our growth strategy is to offer processing services – and other collateral and risk management services – to other exchanges and trading platforms around the world.

#### **Products:**

Throughout the last 30 years, CME has been the leading product innovator in our industry, from financial futures in 1972, to cash settlement in 1981, stock index futures in 1982, CME Globex in 1987 and E-mini contracts in 1997.

That leadership role has positioned CME with the most diverse and successful product line in our industry. Like technology, product innovation today at CME is becoming increasingly sophisticated. We work closely with market users to continually reassess product design, delivery system, trading conventions, pricing structure and other features that drive demand for our products.

In addition to enhancing our existing core product lines, we continue to create new products. Many of our new products are more complex and highly structured to meet the needs of more narrowly defined customer segments. While such products could not be easily or economically launched in the past, electronic trading enhances our opportunity for success.

#### **Expanding Global Distribution:**

CME has been working diligently over the last three years to dramatically expand global distribution and access to our GLOBEX system. We have done this by streamlining our application programming interfaces. In addition, we have introduced more flexible connectivity options, including user defined solutions which significantly reduce costs.

To expand the global distribution of our products, last year we installed telecommunications hubs in Dublin, Gibraltar, Frankfurt, Amsterdam, Paris and Milan, in addition to the one we installed in London in 2002. This growth initiative has been successful, allowing European customers to dramatically reduce their trans-Atlantic telecommunications costs. We launched a similar hub in Singapore in June of this year, and three customers are already connected and trading.

In tandem with these technology enhancements and cost efficiencies, we put in place aggressive incentive pricing plans in both Europe and Asia to promote CME products and accessibility to CME Globex to new customers in those parts of the world.

The strong early response to this program suggests that we are succeeding in our strategy to bring new customers to CME who will find our products to be an attractive alternative to comparable euro-denominated products.

Another avenue of growth for us is to attract new distribution channel partners with the capacity to reach large numbers of nontraditional futures customers. We increased access to our products through an agreement with Bloomberg which allows all 180,000 screens worldwide to access CME products on CME Globex. Additionally, as we continue to expand trading activity in our popular E-mini contracts, we are implementing connectivity agreements with E\*TRADE and Schwab's CyberTrader. These new distribution channels allow us to reach the emerging professional equity retail sector which increasingly finds E-mini contracts more attractive than cash equities, equity options and ETFs.

Most recently, we announced a growth initiative with Reuters, where we will be offering CME's electronic foreign exchange markets to Reuters' global customer base. This initiative marks the first major linkage of sell side traders in the interbank FX market to CME eFX futures markets, where hedge funds and other major buy side participants play a major role, paving the way for more dynamic and efficient markets.

#### **Common Clearing Link:**

Our transaction processing agreement with the Chicago Board of Trade (CBOT) is up, running successfully and producing even more synergies than any of us could have imagined. This common clearing link with CBOT is providing real savings to our clearing firms and market participants in excess of \$1.8 billion in associated costs.

#### IV. CME's RECOMMENDATIONS

While CME enthusiastically applauds the success of the CFMA and recommends that we retain its historic statutory framework, the reauthorization process offers a valuable opportunity to fine tune that statutory framework based on industry experience. CME offers the following recommendations for consideration:

##### **Security Futures Products:**

CFMA needs to be modified to permit Single Stock Futures to succeed. In my Congressional testimony of June of 2003, I characterized single stock futures as "the CFMA's unfulfilled promise". I am sad to say what was true then remains so even today. As evidenced by their long-time successful use and acceptance in European markets, single stock futures can be a great product with enormous benefits to market users. However, inter-exchange competitive concerns combined with regulatory and legislative turf contests largely mitigated the hope for this product even before it was launched in this country. The regulatory system that has slowly evolved between CFTC and SEC has yet to address key issues and several of the regulations that have been produced thus far are overly burdensome and inflexible, frustrating development of products that would be both useful and desirable to market participants.

A complete fix of the problems with security futures would be to undo the regime of dual regulation that was implemented by CFMA as a compromise of the competing jurisdictional demands of the CFTC and SEC. Having the two regulators (CFTC and SEC) for a new product has proved far from optimal. Ideally, futures exchanges should trade the product as a pure futures contract and securities exchanges should be free to trade it as a securities product. This solution allows competitive forces to determine the outcome—not government. We are not asking for that relief at this time. Instead, we are asking that the agencies put U.S. markets on par with financially sophisticated markets throughout the world. We want to allow clearing houses the freedom to manage their risk in the manner in which every successful private company manages its own risk and the risks it encounters dealing with counterparties. We are asking Congress to direct the agencies to do what was contemplated in 2000 and permit risk based portfolio margining for security futures products. Our goal is to reduce the excessive costs associated with trading security futures products on U.S. markets. No one disagrees that risk based margining is the world standard, safe and effective. As noted below, any opposition to CME's proposal is based on ill conceived notions of competitive parity. The opponents of relief want Congress to suppress a potential competitor because they have been unable to get appropriate regulatory relief.

**What we propose and how it works:** We propose directing the Federal Reserve Board, or the SEC and CFTC jointly if so delegated by the Board, to prescribe regulations to permit risk based portfolio margining for security futures products. The draft amendment language proposed by CME, marked to show changes to current law, is set out below:

Section 7(c)(2)(B) of the Securities Exchange Act of 1934 is amended as follows:

B. Criteria for issuance of rules

Within six months of the date of enactment of this Act, the Board shall prescribe, or, if the authority is delegated pursuant to subparagraph (A)(ii), the Commission and the Commodity Futures Trading Commission shall jointly prescribe, such regulations to establish margin requirements, including the establishment of levels of margin (initial and maintenance) for security futures products under such terms, and at such levels, as the Board deems appropriate, or as the Commission and the Commodity Futures Trading Commission jointly deem appropriate--

i. to preserve the financial integrity of markets trading security futures products;

ii. to prevent systemic risk;

iii. to permit national securities exchanges to recognize historical correlations between and among option classes, related securities and other derivatives and to grant such exchanges authority to adjust, without prior notice or approval, margin levels and intra and inter option offsets in response to changing market conditions.

~~iii. to require that--~~

~~I. the margin requirements for a security future product be consistent with the margin requirements for comparable option contracts traded on any exchange registered pursuant to section 78f(a) of this title; and~~  
~~II. initial and maintenance margin levels for a security future product not be lower than the lowest level of margin, exclusive of premium, required for any comparable option contract traded on any exchange registered pursuant to section 6(a), other than an option on a security future; except that nothing in this subparagraph shall be construed to prevent a national securities exchange or national securities association from requiring higher margin levels for a security future product when it deems such action to be necessary or appropriate; to ensure that the margin requirements (other than levels of margin), including the type, form, and use of collateral for security futures products, are and remain consistent with the requirements established by the Board, pursuant to subparagraphs (A) and (B) of paragraph (1).and~~

iv. to ensure that the margin requirements (other than levels of margin), including the type, form, and use of collateral for security futures products, are and remain consistent with the requirements established by the Board, pursuant to subparagraphs (A) and (B) of paragraph (1).

We have not drafted a provision granting similar relief for security options or equity securities, although we expect that proponents of such relief will come forward with their own proposals. CME does not oppose relief for the security option exchanges.

**What Is Risk-Based Portfolio Margining:** In the futures industry, "margin" is a short-hand description of the performance bond required to secure futures commission merchants and clearing houses against loss if a customer defaults. Risk-based margining is the methodology currently used to set margins for most futures products. The principle underlying risk-based margining is that the performance bond should be set high enough to cover almost any price change that the contract might be expected to experience from one day to the next. The level is determined by reference to historical and likely price moves to estimate the worst historical or worst foreseeable loss over a given period of time.

**Margins on Security Futures Products:** Risk-based margining is not used for Security Futures Products (SFPs) in the U.S. SFPs are margined at the customer level using rule-based margining at a minimum of 20% regardless of the individual product's volatility. For many SFP products, this rate is five or more times the rate that would be required under risk-based margining. Requiring margin far in excess of reasonably predictable losses may make participation in the market too expensive for many who would add to the liquidity and efficient functioning of these markets. This is especially true when foreign competitors employ rational margining systems.

*Example:*

Three largest daily price changes over the past year for Johnson & Johnson SFP

December 16, 2004	4.1%
January 25, 2005	3.6%
October 7, 2004	-3.0%

The current rate (20%) is almost five times the largest price change (4.1%).

In addition, the current rule only requires 20% margins for highly volatile products which under risk-based margining would require much higher margins. CME currently requires the higher risk-based rates for these products.

*Example:*

Three largest daily price changes over the past year for Elan Corp. SFP

February 28, 2005	-70.2%
March 31, 2005	-54.0%
May 2, 2005	22.0%

The rate based on the existing rule (20%) does not even cover the third largest price change over the last year (22%).

The one size fits all approach of rule-based margining results in too much margin being

required for low volatility products and too little being required for highly volatile products.

**Margins on SFP Spreads:** In addition to setting margin rates for individual products, rates are set for spreads between two different products or contracts.

*Example:* A portfolio contains one long August 3M SFP and one short September 3M SFP. 3M's earnings release is higher than Wall Street expected. The price of the August 3M SFP changes from \$7,300 to \$7,400 and the price of the September 3M SFP changes from \$7,400 to \$7,490. Therefore, the portfolio makes \$100 on the long August position and loses \$90 on the short September position for a net gain of \$10.

The prices of the two contracts in the example above are highly correlated and usually move by similar amounts because they both have the same underlying security. Because the long contract is likely to make money when the short contract loses money and vice versa, the portfolio overall is not likely to lose very much. Rather than charging the full margin on each of the two contracts (\$2,960 in the example above), a calendar spread rate is set based on the volatility of the differences in the prices between the two contracts (\$370 in the example above).

Spread rates for most futures are set using risk-based margining but for SFP calendar spreads, rates are set using rule-based margining. SFP spreads at the customer level are set at 5%. The same issues that arise using rule-based margining for individual products arise when using rule-based margining for spreads. The volatility of most SFP calendar spreads is much lower than the 5% rate and market participants are not being given enough credit for the dramatic risk reductions they have put into place when they put on calendar spreads.

*Example:*

Three largest daily spreads over the past year for 3M SFP

March 18, 2005	0.5%
February 14, 2005	0.4%
February 23, 2005	0.2%

The current rate (5%) is 10 times the largest spread over the past year (0.5%).

In addition to the calendar spreads described above, spreads can be offered between different products. For example when two SFPs are highly correlated for some reason (e.g. they are both in the same industry), margins can be reduced when a portfolio contains positions in both of these companies on opposite sides of the market. An example of this would be a portfolio that is long the Ford Motor Company SFP and short the General Motors SFP. Another type of spread that could be offered is between broad-based indices and SFPs. For example, the Nasdaq 100 contract vs. Nasdaq 100 Tracking Stock SFP. Both are futures based on the value of the Nasdaq 100 and they are very highly correlated. There are many of these spreads offered between different

futures products that are highly correlated, such as S&P 500 vs. Nasdaq 100 or soybeans vs. soybean oil. These types of spreads are not currently allowed for SFPs.

**Margins on SFP Options:** Finally, rule-based margining for customer level accounts precludes market participants from receiving full credit for the reduced risks they carry when their portfolios contain options on futures to offset their futures positions. Risk-based margining takes these offsets into account by calculating total gains and losses on futures and options on futures positions for an entire portfolio.

**What The World Does:** CME performed a global analysis on the margining treatment of single stock futures (SSF) and single stock options (SSO), which we will be happy to make available to the Committee. Our study unequivocally demonstrates that financially sophisticated regimes and regulators chose risk based portfolio margining as the safest and most efficient way to calculate and collect performance bond.

Outside of the United States, portfolio margining is applied to SSF 100% of the time and 99.86% of SSO activity. International markets currently house 96% of the world's single stock futures activity, overwhelming the domestic markets. The picture is different in the SSO market with the US market being much larger. For this reason – the dominance of the domestic options market – the percentages showing the use of portfolio based margining in the non-US markets are the compelling numbers – virtually all non-US SSF and SSO business is margined using a portfolio based approach.

The predominant tool for SSF portfolio margining outside the US is SPAN, holding a 59% market share. SPAN is the system created by CME and validated by its worldwide adoption.

**Conclusion:** Risk-based margining has been used successfully for most futures products in the U.S. since 1988 and is already used for SFPs in many countries including India, Singapore, Spain, and the UK. It takes into account the risk offsets present in individual portfolios and results in higher margin requirements for those portfolios with positions in exceptionally volatile products. Using risk-based margining would allow customer level accounts to receive margin breaks for offsetting positions but would still allow those setting the requirements to determine what offsets are allowed and the magnitude of those offsets.

**Why The Option Exchanges Want More:** There is no controversy among industry participants respecting the soundness and value of a properly operated risk based portfolio margining system for security futures, or, for that matter, for security options. The security option exchanges have been concerned that the SEC has been slow to permit that system and has argued that they will suffer competitive harm if SSF exchanges get relief before the SEC allows the options exchanges similar relief. The argument is unsound on its face: it urges that bad business practices be forced on security futures markets to protect option exchanges from an unresponsive regulator. The proper solution is obviously to direct the SEC to approve appropriate margining treatment for options exchanges.

But even beyond the intrinsic unfairness of the argument, the practicalities demand that the efforts of the securities option exchanges to deny relief to the SSF exchanges be rejected. The options exchanges claim they will suffer competitive injury. This claim is baseless. The average daily trading volume of the option exchanges is about 5,000,000 contracts per day. One SSF exchange has already failed and the other trades about 6,000 contracts on an average day. No customer has stopped trading options to trade security futures products. No one has ever marketed or touted security futures products as a substitute for security options. There is no real threat to any legitimate interest.

CME's proposal eliminates the requirement that margins on security futures and on options be identical. In a risk based portfolio margining system, that requirement is unworkable. Each clearing house uses its own software to perform the analysis of portfolio risk. While all clearing houses use similar methodologies, the results of the calculations will be different, though immaterially so.

#### **Defining Broad Based Security Indexes:**

The Commodity Exchange Act (CEA) promulgated in 1974, provided the CFTC with exclusive jurisdiction over transactions involving the sale of commodities for future delivery. See 7 U.S.C. §2(a)(1)(A). A dispute between the SEC and CFTC regarding futures on securities and security indexes resulted in the Shad/Johnson Accord, which allocated jurisdiction between the agencies. In 1981, in codifying the Shad/Johnson Accord, Congress confirmed the CFTC's exclusive jurisdiction over futures on broad-based security indexes. See 7 U.S.C. 2(a)(1)(C)(ii). Approximately 100 futures contracts on broad-based security indexes—both domestic and foreign—were approved for trading between 1975 and 2000 when the CFMA was passed.

Prior to passage of the CFMA, the CFTC coordinated with the SEC in approval of broad-based security indexes. Congress maintained the CFTC's exclusive jurisdiction over futures on broad-based security indexes in the CFMA. Congress only provided joint jurisdiction with the SEC over futures on single stock and narrow-based security indexes—CEA §2(a)(1)(D)—NOT with respect to futures on broad-based security indexes. CFMA only defined one class of broad based security indexes and left it to the agencies to create an inclusive definition.

The ramifications of this problem are significant. The US markets are at a competitive disadvantage vis a vis foreign competitors who offer these products. What is at stake here is our competitiveness and our leadership in product innovation.

Our proposal that Congress compel the agencies to promulgate a broad based index definition is necessary to fill in the statutory void that the agencies left unattended for the past five years. The statutory terms distinguishing between broad-based and narrow-based security indexes apply to all securities, but were drafted without clear consideration of the significant differences in size and trading velocity between equities and fixed income securities. U.S. fixed income securities are not typically traded on organized exchanges, and their trading volume is significantly smaller than stock

volume. Foreign exchanges also trade much smaller volumes. CFMA did not distinguish between the two very different classes of securities or the different national markets with the result that the same criteria are applied in determining which indexes can be the basis for futures contracts.

It is almost universally accepted that exchange-traded futures and options are complementary to cash products, and can lead to significant improvements in transparency and liquidity in those cash markets. Market regulators are concerned about the lack of liquidity and transparency in U.S. fixed income markets and have made some efforts to improve the situation, with mixed success. Therefore it is tragic that the distinctions drawn for equity markets are a great deterrent to listing futures on indexes of corporate bonds, security-based swaps and other fixed-income-related instruments. In a recent joint order of the SEC and CFTC the Commissions confirmed this view:

"The statutory definition of the term narrow-based security index is designed to distinguish among indexes comprised of individual stocks. As a result, certain aspects of that definition are designed to take into account the trading patterns of individual stocks rather than those of other types of exchange-traded securities, such as options. However, the Commissions believe that the definition is not limited to indexes on individual stocks. In fact, Section 1a(25)(B)(vi) of the CEA and Section 3(a)(55)(C)(vi) of the Exchange Act give the Commissions joint authority to make determinations with respect to security indexes that do not meet the specific statutory criteria without regard to the types of securities that comprise the index." *Commodity Futures Trading Commission Securities and Exchange Commission, Release No. 34-49469, Joint Order Excluding Indexes Comprised of Certain Index Options from the Definition of Narrow-Based Security Index pursuant to Section 1a(25)(B)(vi) of the Commodity Exchange Act and Section 3(a)(55)(C)(vi) of the Securities Exchange Act of 1934*

The CEA does not adequately define broad based security indexes, subject to the exclusive jurisdiction of the CFTC, and narrow based security indexes subject to joint SEC and CFTC jurisdiction. What the SEC and CFTC have done to date by joint order has offered very narrow relief and is contrary to CFMA's model for sound development of new futures products. The agencies have not negotiated a general joint order that would clarify the issues that Congress expected them to resolve on this point. Currently, relief must be sought through costly, time consuming individual petitioning for a joint order every time a new product is conceived. This is inconsistent with the CFMA's incentives for market innovation. As a result, futures exchanges and U.S. futures commission merchants have been unable to provide their customers with broad based indexes on U.S. debt obligations, foreign debt obligations and foreign equity securities. The CFTC, futures exchanges and FIA are in agreement in principle that this should be fixed now.

**What We Propose And How It Will Work:**

To accomplish the objective of advancing the development of broad based index products while preserving the respective jurisdictions of the two relevant agencies, CME proposes that Congress mandate a joint process by those agencies in accord with the following language:

"The Commodity Futures Trading Commission and the Securities and Exchange Commission are hereby directed to exercise the authority granted by Section 1a(25)(B)(vi) of the Commodity Exchange Act and Section 3(a)(55)(C)(vi) of the Securities Exchange Act of 1934 jointly to establish criteria, by rule, regulation or order, to exclude indexes based on U.S. debt instruments, other U.S. securities, foreign equities and foreign debt instruments from the definition of the term "narrow-based security index." Such criteria shall be adopted and made effective within six months of the enactment date of this Section. Such criteria shall be consistent with the capitalization, trading patterns and trade reporting conditions in the market for such securities and shall exclude from the definition of the term "narrow-based security index" indexes that include a representative sample of a class of securities in the relevant market if the index is not readily susceptible to manipulation. If no joint final rule, regulation or order has been made effective within six months of the enactment of this section, the Commodity Futures Trading Commission shall be authorized to establish criteria, pursuant to Section 1a(25)(B)(vi), permitting entities subject to its jurisdiction to trade futures on indexes based on U.S. debt instruments, other U.S. securities, foreign equities and foreign debt instruments which the Commission determines should be included in the definition of the term "non-narrow-based security index."

**Preventing Fraudulent Off-Exchange Retail Futures Trading:**

The CFMA needs fine tuning respecting CFTC jurisdiction over retail trading of futures contracts that have been crafted to slip into the *Zelener* loophole. Off exchange promotion of futures contracts to retail customers is a continuing source of injury to consumers, embarrassment to the industry and an unnecessary draw on the resources of the CFTC. In particular, over the past four years of the CFMA, the CFTC has brought 70 enforcement actions involving 267 companies and individuals for illegal retail foreign exchange trading. CFTC estimates that these cases involved trading with over 20,000 customers and resulted in imposition of over \$240 million in penalties and restitution orders. This is just the tip of the iceberg. The confluence of the massive continuing frauds committed against retail customers in the OTC foreign exchange ("FX") market, and the recent, unfortunate decision of the 7<sup>th</sup> Circuit Court of Appeals in *CFTC v. Zelener*, compel this industry to reexamine the public policy implications of how the CFMA addresses retail foreign exchange futures and the threshold definition of what transactions should be subject to CFTC jurisdiction.

The fact that the CFTC is compelled to devote substantial resources to protecting retail customers from widespread fraud in the OTC FX market is evidence enough that a serious problem exists with the CFMA that cries out for reform. Moreover, in the

aftermath of the Zelener decision, OTC dealers apparently can offer a retail product that all of us in this room today would agree is a futures contract but which has now been defined by the court to be a cash product outside of the CFTC's jurisdiction. Under the Zelener case, it does not matter what the dealer actually does or what the customer actually expects. The sharp operators and bucket shops have already figured out that the rationale of the Zelener opinion can apply to commodities other than FX. How soon will it be before the CFTC's jurisdiction and its retail consumer protections are reduced to irrelevance?

At a minimum, the retail investing public needs an amendment that will preclude dealers from end-running CFTC's jurisdiction by simply inserting a one line caveat on their internet sites notifying counterparties that the dealer is not absolutely obligated to enter into an opposite, offsetting transaction or that under some circumstances an opposite transaction will not offset existing positions. The challenge for the futures industry---and this Committee--- is to find an effective solution that will politically survive the reauthorization process.

Our Zelener fix reduces CFTC's regulatory costs and burdens and makes it possible to put the crooks out of business before they have spent their ill-gotten gains or moved the money offshore. Our proposal permits the CFTC to shut down those scamsters who have not registered or who sell based on outrageous internet claims before the fraud is completed. Our fix protects the public against fraudulent oil and orange juice scams that will very predictably replace currency scams if the legislative response, as proposed by others, is limited in focus to foreign exchange scams. Our proposed fix protects against this proliferation of the fraud to other commodities without impairing any legitimate business operation.

We propose to create a presumption that leveraged sales of a commodity for future delivery that are offered to retail investors for speculative purposes are futures contracts. This is squarely in keeping with the history and purpose of the CEA. Unless specifically exempted from CFTC regulation by the Treasury Amendment or another exemptive provision of the CEA all pertinent registration and other customer protection provisions apply. Our proposal is simple: CME suggests that the courts be directed to presume what has always been the law, specifically, that leveraged speculative transactions involving retail customers who have no reasonable expectation of delivery are futures contracts. CME's proposed amendment to Section 2(i)(3) of the CEA, set out below, accomplishes this result:

- (3) Leveraged or margined transactions that are offered to, or entered into with, persons who are not eligible contract participants, shall be presumed to be contracts for the sale of a commodity for future delivery subject to this Act if such non-eligible contract participant does not have a commercial use for the commodity or a reasonable expectation of delivery. This presumption may be overcome by showing that the transaction was: (i) primarily marketed to eligible contract participants or (ii) not marketed or offered to non-eligible contract participants as a means to speculate on price movement in the underlying commodity.

CME supports the principle that the CFTC should have responsibility and regulatory authority for futures contracts, but only for futures contracts. We believe that a contract of sale of a commodity for future delivery that involves a retail trader who is trading on a leveraged/margined basis for purely speculative purposes is a futures contract that is subject to the CFTC's jurisdiction. CME believes that retail futures contracts on all commodities should be treated alike, although we emphasize that we do not challenge the Treasury Amendments special treatment of foreign currency futures. CME's proposal:

- REVERSES the hyper technical reading of the Zelener decision that permits traditional futures contracts to escape CFTC scrutiny (i.e. DOES NOT expand CFTC's traditional jurisdiction).
- INSURES that CFTC can protect retail customers for traditional futures contracts before the fraud is consummated and before the money is hidden offshore.
- DOES NOT affect the Treasury Amendment's exceptions for retail foreign exchange transactions executed by banks, brokers and other specifically designated entities and does not give CFTC jurisdiction over such transactions.
- DOES NOT apply to the interbank currency market.
- DOES NOT subject spot or forward transactions in any commodity to CFTC jurisdiction.
- DOES NOT affect commercial entities contracting for actual delivery of commodities.
- DOES NOT limit any of the CEA exclusions or exemptions for OTC transactions involving Eligible Contract Participants.
- DOES NOT PRECLUDE FCMs or their affiliates, banks, broker dealers or their affiliates, insurance companies, or other financial institutions that are otherwise regulated by a federal agency from offering retail foreign currency products to eligible contract participants (i.e. sophisticated investors) or retail customers (i.e. unsophisticated investors).
- DOES NOT preempt state law enforcement against fraudulent activity (i.e. makes no change in existing CEA provisions permitting states to take anti-fraud actions).

Some parties to this debate are proposing that the CFTC be given responsibility for prosecuting fraudulent activity involving certain off-exchange currency contracts, if a retail customer is involved, regardless of whether the contract is a future. However, they would exclude all similar fraud involving any other commodity from such CFTC anti-fraud jurisdiction. The proponents of such proposals refuse to concede that such

contracts are futures, thus depriving CFTC of any power to control who is selling these products, how they are being sold, whether the customers' money is segregated, whether the firm is financially sound, etc. The result is that CFTC's entire retail consumer protection regime is avoided, which not only is bad news for the retail customer but is an open invitation to fraudsters to expand their victimization of the retail market. These proposals deprive CFTC of any effective power to shut down the fraudulent operators, bucket shops and boiler rooms before they have swindled unsophisticated retail customers and either spent the money or shipped it off-shore. Such proposals leave CFTC to employ expensive and time consuming litigation against individual fraudsters which usually produces little, if any, compensation for the defrauded customers. CME opposes such ineffective and insufficient proposals and urges Congress to fashion legislation which is responsive to the broad threat facing retail customers. That threat is not just limited to being scammed on currency transactions. The contract used in *Zelener* can be used with any commodity. If Congress fails to adequately fix the *Zelener* problem it will leave the door open to broad and continuing fraud of unsuspecting investors.

To that end, CME's proposal provides an effective means of preventing the type of fraud we have already seen regarding currency contracts from being used to perpetuate abuse with any other commodity. And our proposal does so without expanding CFTC's jurisdiction beyond its area of expertise and its traditional exclusive authority over commodity futures. CME's proposal uses CFTC's traditional exclusive jurisdiction over retail futures and thereby empowers the agency to utilize its entire set of retail consumer protections to more effectively and efficiently stop fraud at its earliest stages before victims are actually scammed.

#### **V. CONCLUSION:**

The CME, its customers and the financial markets have prospered to the substantial benefit of the nation's economy under the CFMA. In the current reauthorization process, Congress faces the challenge of making discreet corrections to the CFMA to materially improve the utility, efficiency, competitiveness and fairness of our futures markets for our customers and all market participants. CME looks forward to working with the Banking Committee and the Agriculture Committee to produce legislation that meets that objective.

**PREPARED STATEMENT OF MEYER S. FRUCHER**

CHAIRMAN AND CHIEF EXECUTIVE OFFICER, PHILADELPHIA STOCK EXCHANGE

ON BEHALF OF

THE U.S. OPTIONS EXCHANGE COALITION: AMERICAN STOCK EXCHANGE,

BOSTON OPTIONS EXCHANGE, CHICAGO BOARD OPTIONS EXCHANGE,

INTERNATIONAL SECURITIES EXCHANGE, PACIFIC EXCHANGE,

PHILADELPHIA STOCK EXCHANGE, AND THE OPTIONS CLEARING CORPORATION

SEPTEMBER 8, 2005

I am Meyer S. Frucher, Chairman and Chief Executive Officer of the Philadelphia Stock Exchange (Phlx). I appear today on behalf of the Philadelphia Stock Exchange and the five other United States options markets: The American Stock Exchange, the Boston Options Exchange, the Chicago Board Options Exchange (CBOE), the International Securities Exchange, the Pacific Exchange, and our clearinghouse, The Options Clearing Corporation. Together, we comprise the U.S. Options Exchange Coalition. Our markets trade all the exchange-traded security options in the United States, such as options on individual stocks, stock indexes, exchange-traded funds, debt securities, and foreign currency. These markets provide the major hedging instruments for the U.S. stock market. The U.S. Options Exchange Coalition welcomes this opportunity to provide its views on reauthorization of the Commodity Futures Trading Commission (CFTC).

We welcome the Committee on Banking, Housing, and Urban Affairs' participation in CFTC's reauthorization. The Committee has an important role to play in the issues under consideration because of its oversight of three of the four members of the President's Working Group on Financial Markets (President's Working Group)—the Department of the Treasury, the Federal Reserve Board, and the Securities and Exchange Commission—as well as its jurisdiction over securities and over-the-counter derivatives. As a part of the reauthorization, the Senate Committee on Agriculture, Nutrition, and Forestry recently reported S. 1566, the Commodity Exchange Reauthorization Act of 2005, to reauthorize the CFTC. This bill touched on a number of issues within the Banking Committee's jurisdiction. The U.S. Options Exchange Coalition is focused on one aspect of the CFTC reauthorization and S. 1566—the treatment of security futures products (that is, futures on individual stocks and narrow-based stock indexes).

The U.S. Options Exchange Coalition's interest in the CFTC reauthorization is to maintain the competitive balance between security futures and security options established by Congress in 2000 in the Commodity Futures Modernization Act (CFMA). S. 1566's provisions dealing with security futures would destroy this balance by removing the consistent margin treatment between security options and security futures. The U.S. Options Exchange Coalition has a proposal that would preserve this balance while hastening the use of risk-based portfolio margining for both security futures and security options. We urge the Committee to endorse the principle of regulatory parity between security futures and security options as it moves forward with CFTC reauthorization.

In the U.S. Options Exchange Coalition's view, security futures and security options should be regulated in a consistent manner in order to preserve competitive fairness. Congress made consistent regulation the cornerstone of the Congressional compromise that led to the CFMA and the introduction of security futures trading. Nothing has occurred since the enactment of the CFMA that should lead Congress to change this policy of regulatory parity between security futures and security options. As discussed in detail below, our proposal would maintain this important objective while providing margin relief for security futures and security options. To accomplish this, our proposal would direct the SEC and CFTC to adopt rules within 9 months permitting consistent portfolio margin treatment for both products. We strongly urge Congress to follow our approach.

**The CFMA Was Enacted Based Upon Consistent Regulation**

During consideration of the CFMA, Congress reviewed whether and how security futures products should be permitted. Prior to the CFMA security futures had been prohibited since an SEC-CFTC jurisdictional accord in 1982. Futures on broad-based stock indexes were permitted, but not futures on individual stocks or on a narrow-based index of securities. The prohibition emanated from a lack of consensus on whether to regulate these products as securities or futures. In 1999, in anticipation of CFTC reauthorization, the President's Working Group advised Congress that futures on individual stocks and narrow-based indexes should be permitted to trade if they were appropriately regulated. Appropriate regulation of the product was

based on the fact that futures on individual stocks and narrow-based indexes had characteristics of both securities and futures.<sup>1</sup>

When the CFTC came up for reauthorization in 2000, the futures industry advocated a removal of the prohibition on futures on single stocks and narrow-based indexes and options on such futures (collectively called security futures products). While the U.S. Options Exchange Coalition did not object to the introduction of security futures products, it urged Congress to ensure that these products be regulated in manner that provides a level playing field with security options. Consistent with the President's Working Group's findings, the U.S. Options Exchange Coalition argued that security futures are not traditional futures products but are functionally and economically equivalent to security options. As a result, appropriate regulation of these products must include a role for the SEC and key elements of securities regulation. The U.S. Options Exchange Coalition and SEC noted that regulation of security futures solely as futures would pose risks for the securities markets and investors and would create competitive inequities.

In general, the securities laws are designed to protect investors, provide full disclosure of corporate and market information, and prevent fraud and manipulation. The commodities laws are designed to facilitate commercial and professional hedging and speculation and to oversee the price discovery process. Because of the different emphases of the two regulatory schemes, many of the basic regulatory protections that apply to each are very different. The U.S. Options Exchange Coalition, along with the SEC, argued that it would be a mistake to simply impose the futures regulatory model onto a class of products that are the functional equivalent of products regulated under the U.S. securities model.<sup>2</sup> Instead, the U.S. Options Exchange Coalition urged Congress and the SEC and CFTC to determine how to apply relevant portions of the securities regulatory structure to security futures products when lifting the prohibition on these products. Our views were consistent with those of the SEC and the securities industry.

Congress agreed with the U.S. Options Exchange Coalition's position that security futures should be subject to elements of securities regulation. As a result, the SEC and CFTC, under the direction of the relevant Congressional committees, negotiated for many months on a regulatory structure for security futures products. The SEC-CFTC negotiations led to an approach that would regulate the products as both securities and futures under the oversight of both agencies, but with exemptions in certain areas to prevent duplicative regulation. Congress enacted this approach in the CFMA.

A major component of the dual regulation approach was that security futures would be regulated in a manner consistent with comparable security options in key areas, such as insider trading, margin, tax, and transaction fees, in order to provide regulatory parity between these two product groups. Consistent regulation prevents regulatory arbitrage and promotes competitive fairness for equivalent products. It also avoids market anomalies where participants transact in a product to avoid the regulations of an equivalent product rather than for economic or commercial considerations. Indeed, regulatory consistency between security futures and security options was the linchpin of SEC-CFTC agreement for regulating security futures. Without it, the U.S. Options Exchange Coalition, securities markets, SEC, and Congressional securities oversight committees would not have supported the introduction of security futures products.

One of the most important areas of regulatory consistency embodied in the CFMA involved margin. Margin has an important function in derivative contracts. It not only acts as a performance bond but also directly controls the amount of leverage in a derivative such as a security future or a security option. It thus acts to affect the cost of establishing and maintaining a position in the derivative. As security futures and security options are economically equivalent instruments, different margin levels would have a significant impact on the competitive balance between the two products. To ensure a level playing field, the CFMA placed provisions in the Commodity Exchange Act and Securities Exchange Act of 1934 that required security futures margin to be consistent with the margin for comparable securities options. After passage of the CFMA, the SEC and CFTC approved security futures

<sup>1</sup> See, Over-the-Counter Derivatives Markets and the Commodity Exchange Act, Report of the President's Working Group on Financial Markets, November 1999. The President's Working Group noted that "the current prohibition on single stock futures can be repealed if issues about the integrity of the underlying securities market and regulatory arbitrage are resolved."

<sup>2</sup> See, for example, Testimony of William J. Brodsky, Chairman and Chief Executive Officer, Chicago Board Options Exchange, on behalf of the U.S. Securities Markets Coalition, before the Subcommittee on Risk Management, Research and Specialty Crops, U.S. House of Representatives, Regarding the President's Working Group Report on OTC Derivatives and the Commodity Exchange Act, February 15, 2000.

products trading with 20 percent margin, the same margin required for security options.

### **The Current CFTC Reauthorization Should Maintain Regulatory Consistency**

Since their introduction, security futures products have had a slow start. While transaction volume and open interest in these products has grown substantially over the past year, trading interest still remains relatively small. Some of the futures exchanges along with the CFTC have questioned whether the dual regulatory approach has burdened security futures products, and in particular, whether the application of 20 percent margin has hampered the growth of the product. As a result, the Chicago Mercantile Exchange (CME) offered a proposal for a program that would leave margin setting authority for security futures products solely with the futures exchanges, subject to residual oversight by the Federal Reserve Board (Federal Reserve), and suspend SEC and CFTC oversight of margin for these products. The Senate Agriculture Committee adopted that approach in reporting S. 1566. The U.S. Options Exchange Coalition believes that approach to be seriously flawed because it would end the consistent margin treatment of security futures and security options. Instead, the U.S. Options Exchange Coalition has developed a proposal that would offer margin relief to security futures and security options while maintaining consistency of treatment across these two product groups.

As a preliminary matter, the U.S. Options Exchange Coalition notes that it supports efforts to attract new business to security futures products. While these products compete directly with securities options, they also are complementary to them. Security futures offer our markets opportunities for hedging and arbitrage, and likewise participants in the securities futures markets use security options for hedging and arbitrage. There are a number of reasons why security futures have not yet been a huge success: Their introduction several years ago during a brutal bear market; robust cash equities and options markets that diminish the utility of the products;<sup>3</sup> and the reluctance of broker-dealers to actively market the product to their customers. It is doubtful that margin treatment is a major reason for the lack of success of security futures. After all, with the same margin, security options have experienced record volumes over the past few years.<sup>4</sup> It is also important to understand that more new futures and options on futures products fail than succeed.<sup>5</sup>

Nevertheless, we are sympathetic to the desire of the futures industry to implement portfolio margining for security futures products. In many cases, the current strategy-based margin system for security futures and security options results in collecting more margin than is necessary to prudently protect against potential losses.<sup>6</sup> This over margining is an inefficient use of capital by both security futures and security options customers. However, implementing portfolio margining for security futures must be accomplished in a manner that upholds the framework of regulatory consistency between security futures and security options. We strongly oppose unilateral efforts to reduce margin regulation of security futures without granting consistent treatment for security options. That is why we oppose the security futures margin provisions of S. 1566. By leaving securities futures margin solely up to the futures exchanges, the bill would sever the consistent treatment with securities options which has existed since the introduction of security futures. Security options margin would still be subject to SEC oversight, but security futures margin would have no SEC (or CFTC) oversight whatsoever.

The bill, as reported, would undo the carefully drafted compromise embodied in the CFMA, is unfair to security options, and is unnecessary to achieve the desired results. It is a certainty that if S. 1566 were enacted, the futures exchanges would

<sup>3</sup>Security futures products are offered in a number of countries. For the most part, this product has not garnered much trading volume. In the few countries where securities futures products have encountered success, the country either lacks a very liquid underlying market (so that the futures market becomes more desirable as a mechanism for transactions) or the country imposes tax or other fees on stock trading and not on futures trading (so that persons use futures as a means to avoid these taxes or fees).

<sup>4</sup>Listed security options had an average daily trading volume of 2,883,841 contracts in 2000, 4,690,635 contracts in 2004, and 5,571,704 contract for the first 6 months of 2005.

<sup>5</sup>For example, since 1995, the CME has filed to trade 293 new futures and options on futures contracts. On July 7, 2005, only 32 of these products had any trading volume on that date. Of those, only 10 had trading volume of 1,000 or more contracts.

<sup>6</sup>Under a strategy-based margin system, each option position must be classified as a covered write, spread, straddle or naked long or short position, etc. Once separated into the individual strategy positions, which can be a cumbersome process, margin is calculated separately for each paired off position, or naked position as the case may be, without consideration of any other positions that might further offset the risk of that position. Each strategy has a standard formula for computing the margin requirement that applies to all option classes.

reduce the margin for security futures products far below a level that the SEC would approve for security options, perhaps as low as 5 percent. This would place security options at a large competitive disadvantage to security futures, which is the precise situation that Congress in enacting the CFMA sought to avoid. Given this disparity in margin levels, customers may choose security futures over security options not because of the merits of the product but merely because of its lower cost. S. 1566 unnecessarily puts Congress in the position of granting regulatory advantages to one industry over another.

The U.S. Options Exchange Coalition has developed an alternative approach that would lead to risk-appropriate portfolio margining for both products in a manner that would preserve the consistent treatment endorsed by Congress in the CFMA. We have shared this approach with the SEC, CFTC, CME, and Congressional committees. Under the approach, Congress would direct the SEC and CFTC to adopt joint rules permitting the use of portfolio margining for security futures within 9 months of passage of the legislation, and also direct the SEC to adopt a consistent rule permitting the use of portfolio margining for comparable security options within 9 months of passage of the legislation.<sup>7</sup> Portfolio margin treatment allows instruments' (stocks, bonds, options, and futures) margin to be based upon the aggregate risks of all such instruments in a person's portfolio. Because a portfolio margining system would calculate margin on the greatest loss that could occur in a portfolio if the value of component instruments moved up or down by a certain amount, it is a more precise and efficient margin treatment than the current strategy-based approach used for security options and security futures. It is likely that, in many cases, a portfolio margin approach would reduce the amount of margin needed for security futures and security options for customers while still maintaining adequate risk coverage.<sup>8</sup>

The U.S. Options Exchange Coalition's legislative proposal is consistent with the approach to margin Congress laid out in the CFMA in 2000. Congress gave the Federal Reserve authority over margin for security futures and the ability to delegate this authority to the SEC and CFTC jointly. In delegating margin authority, the Federal Reserve encouraged the agencies to move toward portfolio margining for security futures.<sup>9</sup> Indeed, portfolio margining has been used at the clearinghouse level for security options for many years. In addition, markets in many foreign countries already employ portfolio margining for futures and options, as do most U.S. futures exchanges for products other than security futures. It is a time-tested international methodology, and it is imperative and urgent that the U.S. securities regulatory structure catches up to the rest of the world in using it. Unfortunately, progress toward this goal has been slow and incremental. Recently the SEC approved a proposal to implement a 2-year pilot program to allow portfolio margining for listed broad-based stock index options, index warrants, and related futures and exchange traded funds (ETF's).<sup>10</sup> It took the SEC 3 years after submission of a formal proposal to grant this approval. While the pilot program would have been a good first step several years ago, it is time to move beyond an incremental approach toward the type of comprehensive methodology employed elsewhere that covers a wide range of products and market participants.<sup>11</sup>

Our proposal would accomplish this by mandating that rules permitting portfolio margin for security options and security futures be adopted by a date certain, while preserving the consistent margin treatment between the two product groups. This proposal would produce a win-win situation for security futures and security options markets and compel the SEC and CFTC to act swiftly toward this important goal.

<sup>7</sup>While the Federal Reserve ultimately has authority over securities margin, several years ago it delegated its authority over listed security options to enable the margin for these products to be set by the rules of the options self-regulatory organizations (SRO's) subject to approval by the SEC. Our proposal would direct the SEC, as long as the delegation from the Federal Reserve continued, to pass a rule that permits the SRO's to allow portfolio margining of security options.

<sup>8</sup>While the Coalition proposal specifically addresses portfolio margin for security futures products and security options, the joint rulemaking as well as the separate SEC rulemaking would be free to include other related instruments such as stocks and broad-based stock index futures in a portfolio margin program.

<sup>9</sup>Letter dated March 6, 2001, from Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, to Mr. James E. Newsome, Acting Chairman, CFTC, and Ms. Laura S. Unger, Acting Chairman, SEC.

<sup>10</sup>Securities Exchange Act Release Nos. 51615 (April 26, 2005) and 52032 (July 14, 2005).

<sup>11</sup>While the broad-based index options pilot was approved as a first step, it has overly restrictive provisions as to the accounts eligible to use portfolio margin. A comprehensive rule for portfolio margin should not restrict its use to accounts with very high equity or high net worth institutions. Rather, it should accommodate a wide range of entities that want to use portfolio margin, as is the case for portfolio margin in many foreign markets and in the futures industry.

The 9-month period for rulemaking in the proposal is appropriate, as much of the preliminary work has already been accomplished. The futures industry and CFTC are very familiar with portfolio margining and the securities industry has been working with the SEC over the past few years toward obtaining portfolio margining for securities. This should be a familiar territory for both agencies. The SEC could build upon and expand the broad-based stock index options pilot to adopt rules for all security options and work with the CFTC to adopt consistent rules for security futures. With new leadership at the SEC and CFTC and clear direction by Congress, we believe the two agencies could act quickly to adopt comprehensive rules that would benefit investors and the markets.<sup>12</sup>

In permitting portfolio margining, it is critical that the SEC and CFTC adopt joint rules for security futures and that such rules are consistent with the SEC rulemaking for security options. Due to the historically disparate approach between the SEC and CFTC toward regulation in general and margin regulation in particular, individual rulemaking by each agency would produce different results for comparable products under their jurisdiction. Only Congress can ensure fair and consistent treatment on this fundamental issue by mandating joint rulemaking for security futures and by directing the SEC to adopt the same rules for security options. The SEC and CFTC worked together to adopt rules to facilitate the introduction of security futures after passage of the CFMA. There is no reason why they could not do the same for portfolio margining. The U.S. Options Exchange Coalition and its members stand ready to provide whatever assistance is needed to the SEC and CFTC to adopt rules for portfolio margining as well as to Congress as it deliberates on margin-related issues.

The U.S. Options Exchange Coalition's legislative proposal also contains definitional changes to the Securities Investor Protection Act of 1970 (SIPA). SIPA involves the activities of the Securities Investor Protection Corporation (SIPC). SIPC protects customers if a broker-dealer goes out of business up to specified amounts for customer cash and securities at the broker-dealer. SIPC covers most types of securities, but does not cover certain futures. Changes to SIPA are needed to accommodate portfolio margining by security options customers. Optimally, portfolio margining looks at all related positions in an account to determine the risk of the portfolio and the appropriate level of margin. For example, to fully realize the benefits of the portfolio margining pilot recently approved for options on broad-based stock indexes and ETF's, a customer may choose to have these positions in the same account as positions in broad-based stock index futures and futures on ETF's. Margining of options and futures in one account is called cross-margining. To facilitate cross-margining for such a customer, narrow changes to SIPA are needed to make sure that the customer is protected in the unlikely event of a broker-dealer bankruptcy. These changes would permit the cross-margin accounts of qualifying customers to be treated as "securities accounts" under SIPA and provide that such customers can have appropriate claims against customer property consisting of certain futures in the event of the insolvency of the carrying broker-dealer.<sup>13</sup> Without these changes, portfolio margining cannot be fully implemented and inefficiency in the margining of securities will remain. The U.S. Options Exchange Coalition has discussed these changes with the SEC and the CFTC. It is crucial that Congress adopt these changes as part of the CFTC reauthorization process.

#### **Broad-Based Index Definition**

The CFTC reauthorization touches upon a variety of other issues, such as CFTC jurisdiction in foreign currency markets. The U.S. Options Exchange Coalition does not have a position on most of these other issues. However, the U.S. Options Exchange Coalition does have an interest in potential changes to the definition of narrow-based security indexes. The CFMA contains definitions of narrow-based security indexes in order to differentiate a narrow-based security index future from a broad-based security index future. Narrow-based security index futures are treated as security futures products and are subject to the dual jurisdiction of the SEC and CFTC, while broad-based security index futures are subject to the exclusive jurisdiction of the CFTC. These important definitions were carefully crafted by the SEC and CFTC.

The CFTC and others in the futures industry want to create new definitions for "narrow-based security" indexes based on U.S. debt instruments, other U.S. securities, foreign equities, or foreign debt instruments. These new definitions for narrow-

<sup>12</sup>The Coalition suggests that Congress require a brief status report in the 9-month rule-making period to make sure that the two agencies remain on track.

<sup>13</sup>For example, the definition of customer property under SIPA needs to be amended to include certain commodity futures and commodity option contracts.

based security index for the four product types noted above could result in differences from the same definition applicable currently to an index comprised of U.S. equities. The U.S. Options Exchange Coalition will defer to the judgment of the SEC as to whether such differences would lead to an undesirable result in this area. In any event, the definitions of narrow-based security index should be crafted by the SEC and CFTC *jointly*. While there should be a good reason for any deviation from the definitions adopted by the CFMA, we will defer to the judgment of the two agencies if they jointly decide that the changes are warranted.

### Conclusion

The U.S. Options Exchange Coalition believes that CFTC reauthorization provides an opportunity to bring the benefits of portfolio margining to both security futures and security options in a manner that maintains the CFMA's parity of treatment for security futures and security options. The U.S. Options Exchange Coalition's proposal provides the means for achieving these goals. S. 1566 does not do so. We urge the Committee to maintain the parity of CFMA during reauthorization.

Thank you again for the opportunity to testify at this important hearing. I would be happy to answer any questions that you have.

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## PREPARED STATEMENT OF MARK LACKRITZ

PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

SEPTEMBER 8, 2005

The Securities Industry Association<sup>1</sup> appreciates the opportunity to testify on The Commodity Exchange Reauthorization Act of 2005 (S. 1566). We commend the Committee for your interest in provisions of S. 1566 that are of significant importance to the securities industry.

### Overview

SIA strongly supports reauthorization of the Commodity Futures Trading Commission (CFTC) in 2005, but we oppose the provisions of S. 1566 that go beyond CFTC reauthorization and would amend the Commodity Exchange Act (CEA) and the recently enacted modifications to the CEA codified in the Commodity Futures Modernization Act of 2000 (CFMA). The CFMA enjoyed strong bipartisan support in this Committee and in Congress, and it was well-received in the public and private sectors. In addition to codifying important modernizing amendments to the CEA, the CFMA brought much needed legal certainty to the U.S. over-the-counter (OTC) derivatives markets and provided a statutory framework that has enhanced the competitiveness of U.S.-listed and OTC derivatives markets. Strong U.S. derivatives markets have, in turn, brought important benefits to all sectors of the U.S. economy since enactment of the CFMA. Importantly, the CFMA also established a dual statutory and regulatory framework for the trading of security futures, a class of financial instruments that had previously been prohibited in the United States.

SIA is deeply concerned with two principal areas in S. 1566: (1) provisions addressing the margining of security futures and the status of certain security index futures; and, (2) the scope of language addressing the so-called *Zelener* decision and related foreign exchange issues, including the provisions to limit the scope of permissible activities of broker-dealers.

In relation to security futures, SIA supports agency rulemakings and SRO rule approvals under the CEA and the Securities Exchange Act of 1934 (Exchange Act) that would promote U.S. investor access to a broader range of security futures index products and that would encourage the adoption of portfolio margining. However, SIA believes it is essential that any portfolio margining legislation ensure that *all* financial instruments, including stocks, convertible and equity-linked debt, options, and security and security index futures, be included in a manner that does not es-

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<sup>1</sup>The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated \$236.7 billion in domestic revenue and an estimated \$340 billion in global revenues. (More information about SIA is available at: [www.sia.com](http://www.sia.com).)

establish margin-based competitive disparities. SIA opposes the provisions of S. 1566 that are addressed solely to portfolio margining for security futures.

We understand that retail fraud in connection with speculative foreign exchange activities continues to be problematic, as it was prior to enactment of the CFMA. We do not agree, however, with the assertion that there is a compelling need for modifications to the CEA to address these problems. SIA strongly supports efforts to root out fraud against retail investors, but we believe the provisions of S. 1566 are overly broad and could well give rise to unintended adverse consequences.

## Discussion

### *Portfolio Margining*

The margin requirements for securities and securities derivatives limit the amount of economic leverage that can be achieved in connection with an investor's position in securities or other financial instruments.

Generally speaking, the margin requirements applicable to broker-dealers in connection with securities and securities derivatives are established under Regulation T of the Board of Governors of the Federal Reserve System (FRB) and under rules adopted by exchanges and other self-regulatory organizations (SRO's) and approved by the Securities and Exchange Commission (SEC). In the case of security futures, CEA and Exchange Act provisions also require that security futures margin levels not be lower than the lowest margin requirements applicable to comparable stock options. This latter restriction was adopted in the CFMA to prevent competitive disparities from arising from the application of the margin levels typically required for futures contracts (which are generally lower than those applicable to stocks and stock options).

Today's investment portfolios are increasingly comprised of a wide array of securities and securities derivatives. These positions often have offsetting risk exposures. Under a strict application of the margin rules—without any recognition of the impact of multiple positions on the effective net exposures within a portfolio—the aggregate amount of margin that would be required to be maintained would be equal to the sum of the margin requirements applicable to each individual position.

As a result, the aggregate margin requirements applicable to these portfolios do not reflect the risk-mitigating impact of offsetting positions, thereby leading to over-margining, portfolio inefficiencies, and a misalignment of margin and risk-management incentives. Investors are not incentivized under this approach to engage in risk-mitigating strategies. Excessive margin requirements also impair the competitive position of U.S. brokerage firms competing with non-U.S. financial service firms for the business of foreign customers.

In order to ameliorate these effects, SRO's have adopted rules that recognize certain offsetting positions by reducing the aggregate margin requirements applicable to certain specified position combinations. While these so-called “strategy-based” margin levels provide some relief, they do not comprehensively take into account the exposure offsets found in common portfolios of multiple instruments. This is because they do not take into account all of the types of products and product combinations that may comprise a portfolio and give rise to offsetting exposures.

In recognition of the superiority of portfolio margining as an efficient but prudent means of determining margin requirements, the FRB adopted an amendment to Regulation T in 1998 to provide an exemption for any portfolio margining system permitted by an SRO pursuant to SEC-approved rules.<sup>2</sup>

An *ad hoc* committee of SIA has been working with SRO's and the SEC for several years to expand the use of portfolio margining, and we have made modest, incremental progress during that time. Importantly, regulators have become increasingly familiar with the tools and techniques associated with portfolio margining, and we are hopeful that in the near future considerably greater progress will be made. SIA's portfolio margining committee recently submitted the outline of a proposal to the New York Stock Exchange that, if adopted and approved by the SEC, would be an important step in a process ultimately leading to a system of portfolio margining that encompasses the full range of securities and securities derivatives.

Indeed, SIA strongly supports the use of portfolio margining and believes that it should be available for all statistically correlated portfolio positions, all market participants whose positions are subject to Federal margin regulation, and all accounts, with the following two stipulations.

<sup>2</sup>[63 Fed. Reg. 2805 (Jan. 16, 1998).] Following enactment of the CFMA, in a letter dated March 6, 2001 addressed to the SEC and CFTC, the FRB reiterated its encouragement for the development of “more risk-sensitive portfolio margining approaches for all securities, including security options and security futures products.”

First, portfolio-margining arrangements should encompass and provide parity of treatment for all statistically correlated portfolio positions. Portfolio margining should not be available selectively to certain product categories, but not others, in a manner that might produce a potentially anticompetitive result. Ideally, firms would be permitted to use proprietary models for the purpose of calculating portfolio margin requirements.

Second, any portfolio-margining arrangements should be limited to arrangements that do not give rise to uncertainty as to the availability of deposited margin to satisfy outstanding obligations in the case of insolvency of the carrying firm or its customer.

Thus, SIA strongly supports regulatory initiatives designed to facilitate and promote portfolio margining on a comprehensive basis. Similarly, we would support legislation that encourages SEC and CFTC initiatives to approve SRO rules or to adopt rules implementing portfolio-margining systems consistent with the parameters articulated above.

SIA opposes, however, the portfolio margining provisions currently contained in S.1566. These provisions, among other deficiencies, are too narrowly drawn and have the potential to create inappropriate competitive disparities across competing product markets. SIA also believes, as a general matter, that the nature of the issues presented by portfolio margining are better suited to resolution through the cooperative interaction of the industry, SRO's and Federal agencies, rather than through a prescriptive legislative approach.

#### **Security Futures Index Definitions**

Derivatives on security indices have provided valuable financial tools for the investment community, including retail, institutional, and professional investors. Limitations on investor access to these products arise under the dual regulatory framework for security futures products principally in two contexts: Foreign securities and narrow-based security indices and domestic nonequity indices.<sup>3</sup> The current regime also limits the ability of U.S. brokerage firms to compete with non-U.S. financial services firms in offering transaction execution services to foreign customers trading in futures on foreign securities and narrow-based security indices.

Access to these products requires the cooperative action of the SEC and CFTC. SIA strongly supports cooperative action by the two agencies to adopt the rule-making necessary to make security index futures in these categories available to U.S. investors. Although SIA does not believe legislation to encourage joint rule-making to permit U.S. trading in foreign stock and stock index futures and domestic nonequity securities and security indices is necessary, we would support such an initiative if the SEC and CFTC believe they need a legislative mandate. We oppose the security index definition provisions contained in S.1566.

#### **Retail Foreign Exchange Fraud**

##### *General*

Critics of the decision of the Seventh Circuit Court of Appeals in *CFTC v. Zelener*, 373 F.3d 861 (7th Cir. 2004) argue that the decision created or exposed a significant loophole in the CEA that will purportedly provide a road map for retail fraud in a broad range of commodities.

SIA disagrees with this view and believes that the *Zelener* decision was a correct application of current law and was correctly decided based on the facts in evidence in the case. SIA also does not find credible the claim that the *Zelener* decision will lead to similar decisions in cases involving retail transactions in physical commodities that typically require costly, complex, and burdensome delivery mechanisms.

Moreover, the absence of CFTC jurisdiction over certain categories of retail commodity fraud does not necessarily result in an enforcement vacuum. Recent actions by the State of California<sup>4</sup> and the Federal Trade Commission<sup>5</sup> are indicative of the availability of other enforcement mechanisms for the protection of retail consumers.<sup>6</sup>

<sup>3</sup> Under the current dual regulatory regime, the SEC and CFTC have not adopted the joint rules that would be necessary to permit in options on security futures.

<sup>4</sup> U.S. Commodity Futures Trading Commission and State of California Charge San Francisco Foreign Currency Firm National Investment Consultants, Inc. And Other Companies And Individuals With Fraud, CFTC Press Release July 21, 2005. <http://www.cftc.gov/opa/enf05/opa5099-05.htm>.

<sup>5</sup> Court Order Bars Deceptive Investment Pitches, Federal Trade Commission Press Release, May 17, 2005. <http://www.ftc.gov/opa/2005/05/britishcapital.htm>.

<sup>6</sup> As noted by former Acting CFTC Chair Sharon Brown-Hruska:

Continued

SIA believes that steps to expand CFTC jurisdiction beyond futures should be taken with great care. There are two reasons for this. First, the CFTC has a significant regulatory mission to discharge with respect to the Nation's currently regulated futures markets.

These responsibilities already challenge the agency's resources. Steps that might expand the CFTC's role to that of a national police force for consumer fraud involving credit transactions could place significant additional burdens on the CFTC's resources and continued ability to meet the challenges of an extremely innovative and constantly evolving market.

Second, the very uncertainties that gave rise to the need for the CFMA were themselves the result of the potentially expansive scope of the CEA and overlapping jurisdiction of the CFTC with that of the SEC, bank supervisors, and others. Nearly every prior amendment to the CEA involving the scope of CFTC jurisdiction, with the notable exception of the CFMA, has caused significant jurisdictional disputes or uncertainty with adverse collateral consequences. It is imperative that Congress avoids legislative initiatives that will create these problems in new areas of economic activity—particularly where no compelling public policy case has been presented for enacting legislation that might give rise to such risks.

Nonetheless, SIA welcomes the attention of the President's Working Group on Financial Markets to these issues and supports efforts to eliminate or remediate fraud where the need to do so is identified. Consistent with the principles articulated above, however, it is critical that any such initiative be narrowly drawn to address only the substantive antifraud concerns.

In this regard, we oppose the provisions of S. 1566 dealing with these issues and we have serious substantive, policy, and technical concerns with the language, including concerns regarding the scope of transactions that would be covered by the proposed provisions.

#### *Broker-Dealer Affiliates*

Unrelated to the *Zelener* decision, S. 1566 would cut back significantly existing provisions of the CFMA that permit SEC-registered broker-dealers and their material associated persons (that is, their material affiliates), among other entities, to continue to conduct OTC foreign exchange futures activities with counterparties that do not qualify as eligible contract participants.

SIA understands that this proposal responds to a practice in which firms establish and register 'shell' FCM's for the purpose of permitting under-capitalized and unregulated affiliates to engage in retail OTC foreign exchange futures activities. In the context of SEC-registered broker-dealers or their material associated persons, however, no similar problem has arisen, and there is no basis for concluding that any similar problem will arise in the future.

Most U.S. broker-dealer holding company groups have historically conducted their OTC foreign exchange activities in an affiliate of the SEC-registered broker-dealer. These entities are not thinly capitalized and, as noted above, there is no history of any retail foreign exchange related abuse by these entities or by personnel of the affiliated broker-dealer. Requiring reorganization of this business line and registration of personnel could be costly and burdensome and would be entirely unjustified by the record.

As a result, SIA strongly opposes the provisions of S. 1566 that would modify the scope of permissible activities of broker-dealers or their material associated persons under the existing provisions of CEA Section 2(c)(2)(B).

#### *Unregistered Solicitors*

SIA understands that certain unregulated persons, other than the entities enumerated in existing CEA Section 2(c)(2)(B), have commenced operations as solicitors of OTC foreign exchange futures transactions in which FCM's or FCM affiliates act as counterparty. SIA would not oppose legislative amendments that would require such solicitors to be registered with the CFTC where they are not an entity (or an employee of an entity) enumerated in CEA Section 2(c)(2)(B) or otherwise regulated.

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"I would point out that our overall track record in the forex area is favorable. Since the passage of the CFMA, the Commission, on behalf of more than 20,000 customers, has filed 70 cases and prosecuted 267 companies and individuals for illegal activity in forex. As a result of those efforts, we have thus far imposed over \$240 million in penalties and restitution. Of the 70 cases that have been filed thus far, the Commission has lost only three."

Testimony of Sharon Brown-Hruska, Hearings of the Senate Committee on Agriculture, Nutrition, and Forestry, March 8, 2005.

### Legal Certainty Concerns

The CEA is a complex statutory scheme, reflecting, as it does, the richness and complexity of this nation's financial markets. In enacting amendments to the CEA, unintended consequences can readily occur, whether in the form of legal uncertainty, inappropriate restrictions on legitimate activity or competitive disparities.

A potentially significant example of this problem is presented in the context of the Report of the Senate Committee on Agriculture, Nutrition, and Forestry accompanying S. 1566. That Report notes:

The Committee concurs with the CFTC's consistent position that even if a transaction is excluded from the CFTC jurisdiction under Section 2(g), the false reporting of such a transaction is a separate act and remains a violation of Section 9 so the CFTC has authority to prosecute.<sup>7</sup>

SIA agrees that the CFTC has jurisdiction under Section 9 for a false report covered by that section even though, had the transaction falsely described actually occurred as described, it would have been eligible for the exclusion in Section 2(g). A transaction reported falsely by definition did not occur and therefore cannot satisfy the requirements of an exemption applicable to actual transactions. For that reason, the CFTC's enforcement position is justified and we agree with the conclusion reached in the Report.

We do not agree with the basis cited in the Report for its conclusion. The Report suggests that the exclusion provided under Section 2(g) (and, presumably, the other statutory exclusions contained in the CEA) do not, for example, cover false "statements" because they are "separate" from the excluded transactions. The Report thus appears to distinguish between "transactions" that are exempt, on the one hand, and "statements" relating to transactions, which, according to the Report, are "separate" from the transactions and are therefore not exempt. The drawing of a general distinction between exempt or excluded transactions under the CEA and related "statements" or conduct of transactors is not justified under the CEA and could reintroduce significant uncertainty that the CFMA was expressly enacted to eliminate.

Securities-based swaps, for example, are excluded from regulation under the CEA (including the CEA's antifraud provisions) pursuant to Section 2(g). Congress instead explicitly subjected securities-based swaps to antifraud provisions under the securities laws in Title III of the CFMA.

The above-quoted Report language would suggest, however, that statements made in connection with securities-based swaps would be subject to CEA antifraud provisions. This is plainly inconsistent with Congressional intent. Moreover, the logic applied to "statements" could be equally applied to other conduct that is independent of the "transaction", thus giving rise to broader uncertainty as to the extent to which provisions of the CEA regulate statements, communications, and other conduct of transactors in connection with the broad range of banking, securities, and other financial transactions Congress assumed it had expressly excluded from regulation under the CEA. Such uncertainty is unacceptable and should be dispelled.

### Conclusion

The CFMA resolved many significant issues and did so in innovative ways. This has enabled the U.S. derivatives market to provide important benefits for the U.S. economy. As noted above, the complexity of the products subject to the CEA, as well as those covered by exclusions from the CEA, are complex and extremely difficult to define. History has shown that a lack of clarity under the CEA can produce significant adverse consequences. As such, we believe it is extremely important that Congress proceed cautiously to avoid unintended adverse consequences of the type potentially presented by the Report text cited above.

SIA is eager to work with the Committee and its staff to achieve your legislative objectives in a constructive manner that preserves the many benefits of the CFMA.

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**PREPARED STATEMENT OF ROBERT G. PICKEL**  
EXECUTIVE DIRECTOR AND CHIEF EXECUTIVE OFFICER  
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

SEPTEMBER 8, 2005

Mr. Chairman, Senator Sarbanes, and Members of the Committee. I am Robert G. Pickel, Executive Director and Chief Executive Officer of the International Swaps

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<sup>7</sup> Report at page 6.

and Derivatives Association, Inc. (ISDA). I appreciate the Committee's invitation to appear today to present ISDA's views on proposed legislation to reauthorize the Commodity Futures Trading Commission (the CFTC), which administers the Commodity Exchange Act (the CEA).

### **Overview**

ISDA is an international organization, and its more than 650 members in 48 countries include the world's leading dealers in swaps and other off-exchange derivatives transactions (OTC derivatives). ISDA's membership also includes many of the businesses, financial institutions, governmental entities, and other end users that rely on OTC derivatives to manage the financial, commodity market, credit, and other risks inherent in their core economic activities with a degree of efficiency and effectiveness that would not otherwise be possible.

Congress substantially amended the CEA in the Commodity Futures Modernization Act of 2000 (the CFMA). The CFMA was adopted with broad bipartisan support after careful consideration over several years by four Congressional Committees, including this Committee, and with the active support of the President's Working Group on Financial Markets (the PWG); namely, the Secretary of the Treasury, the Chair of the Board of Governors of the Federal Reserve System, the Chair of the Securities and Exchange Commission, and the Chair of the CFTC.

The CFMA was intended to provide regulatory relief for the futures exchanges; ensure legal certainty and regulatory clarity for OTC derivatives; and remove the ban on single-stock futures trading. ISDA is of course principally interested in those provisions of the CFMA that were enacted to provide legal certainty and regulatory clarity for OTC derivatives.<sup>1</sup> For the reasons explained in Part II of this statement, ISDA believes that, based on the experience to date under the CFMA, Congress did achieve its objective of providing legal certainty and regulatory clarity for OTC derivatives in a manner that has reduced systemic risk and encouraged financial innovation. Moreover, from all indications, the CFMA seems to have been a broad-based success for the capital markets generally. ISDA commends the CFTC for the effective manner in which it has implemented the CFMA in accordance with Congressional intent. ISDA has and will continue actively to support passage of legislation to reauthorize the CFTC.

As the Committee is aware, there have been numerous proposals to utilize the reauthorization process as a vehicle for substantive amendments to the CFMA, including amendments relating to OTC derivatives. For the reasons discussed Parts II and III of this statement, ISDA believes there is no compelling need to make substantive changes to those portions of the CFMA governing OTC derivatives. While this Committee should of course consider the views of those who take a different position and advocate such amendments, we urge the Committee to take a cautious approach to reopening the OTC derivatives provisions of the CFMA. If any amendments are agreed to, they should be specifically targeted to identified problems requiring legislation and carefully crafted to avoid unintended collateral consequences that could undermine the legal certainty provided for OTC derivatives by the CFMA. In this connection, we also urge the Committee to ensure that all proposed substantive amendments to the CFMA are subject to advance review by the Committees of jurisdiction. Our experience in recent years demonstrates that the use of freestanding amendments offered to separate legislation without advance review by the Committees of jurisdiction is an undesirable method of considering changes to the CFMA.

### **OTC Derivatives Under the CFMA**

As noted, ISDA is principally interested in the provisions of the CFMA that provide legal certainty for OTC derivatives. The phrase "legal certainty" means simply that the parties to OTC derivatives transactions must be certain that their contracts will be enforceable in accordance with their terms. The availability of OTC derivatives transactions within a strong legal framework, such as that provided by the CFMA, is of vital importance. Any uncertainty with respect to the enforceability of OTC derivatives contracts obviously presents a significant source of risk to individual parties to those specific transactions. Moreover, any legal uncertainty creates risks for the financial markets as a whole and precludes the full realization of the powerful risk management benefits that OTC derivatives transactions provide.

As this Committee is aware, the CFMA framework for providing legal certainty is based on a long-standing consensus among Congress, key financial regulators, including the CFTC, and others that OTC derivatives transactions generally are not

<sup>1</sup> ISDA's primary members are substantial users of the regulated futures exchanges. ISDA therefore supported the provisions of the CFMA that provided regulatory relief to the exchanges.

appropriately regulated as futures contracts under the CEA.<sup>2</sup> The OTC derivatives provisions of the CFMA were intended by Congress to resolve the legal certainty issues with finality and, at the same time, reduce systemic risk and encourage financial innovation. ISDA's experience over the past several years indicates that these objectives have been achieved.

A survey of corporate usage of derivatives released by ISDA in April 2003 indicated that 92 percent of the world's largest businesses use OTC derivatives for risk management purposes and that 94 percent of the 196 U.S. companies included in the survey do so. Significantly, the use of OTC derivatives to hedge interest rate, foreign currency and credit default risks increased substantially in the last 4 years, evidencing the importance of OTC derivatives as a tool to manage risk in periods of economic downturn and uncertainty. As Federal Reserve Chairman Alan Greenspan noted before this Committee on March 2, 2002, OTC derivatives "are a major contributor to the flexibility and resiliency of our financial system."<sup>3</sup>

The reductions in systemic risk resulting from enactment of the legal certainty provisions of the CFMA have *not* come at the expense of financial innovation. New types of OTC derivatives have gained increased market acceptance since enactment of the CFMA. For example, the significant growth in credit default swaps to manage credit risk has been greatly enhanced by the legal certainty provisions of the CFMA. Similarly, businesses ranging from ski resorts to beverage producers have begun to use weather derivatives to hedge the risk of adverse climate conditions on their businesses. Again, the legal certainty provisions of the CFMA have encouraged dealers to develop, and businesses to use, an increasing range of new kinds of OTC derivatives to manage additional types of risk. Finally, the legal certainty provisions of the CFMA removed the regulatory barriers to clearing with respect to OTC derivatives and, while collateralized transactions remain more prevalent, clearing proposals have been advanced recently and the emergence of these proposals attests to the positive effects of the CFMA on financial innovation.

To summarize, ISDA's experience to date under the CFMA indicates that Congress did indeed achieve its objective of providing legal certainty and regulatory clarity for OTC derivatives in a manner that would both reduce systemic risk and encourage financial innovation. Equally significant, three events since the passage of the CFMA have in many ways "stress tested" the OTC derivatives markets and the applicable provisions of the CFMA itself. The results have been encouraging.

First, there is no question but that the CFMA structure enabled financial institutions and the American business community to deal with the economic downturn in the early part of this decade in a more effective manner. The well-publicized events leading to Enron's bankruptcy filing in December 2001 presented a second test. Enron raised serious concerns involving accounting practices, securities law disclosures, and corporate governance policies. These issues received serious attention from policymakers and led to intensive investigations and enforcement actions, including actions based on the CFMA, by the CFTC and other regulators. Had Enron complied with accounting and disclosure requirements, it could not have built the "house of cards" that eventually led to its downfall. The market in the end exercised the ultimate sanction over Enron and the market for OTC derivatives functioned as expected and with no apparent disruption.

The equally well-publicized transactions of Enron and others in or with respect to the California energy market presented a third test involving different public policy questions; namely, the design of the California electricity market, the lack of adequate reserves, demand response relative to growing electricity demand, and possible manipulation of the wholesale market. ISDA views any credible allegations of "manipulation" in financial or other markets as a serious matter requiring attention and therefore welcomed the investigations by the appropriate Federal agencies and departments, including the CFTC, the Federal Energy Regulatory Commission (FERC), and the Department of Justice. Both FERC and the CFTC initiated a series of enforcement actions employing the tools available under existing law, including the CFMA. Based on this experience, there does not appear to be any specific evi-

<sup>2</sup>In the late 1980's, the use of interest rate and currency swaps and other OTC derivatives transactions to manage financial risks grew rapidly. At that time, there was a consensus that OTC derivatives were not "futures" contracts. Nevertheless, because of certain perceived similarities between OTC derivatives and exchange traded futures contracts, there was residual concern that the CFTC or a court might treat OTC derivatives contracts as futures, which would render them illegal and unenforceable by reason of the CEA's exchange trading requirement.

<sup>3</sup>Moreover, as discussed more fully below, the reduction in systemic risk resulting from the use of OTC derivatives was also evident in the energy markets following the collapse of Enron in 2001. Indeed, it appears that the legal certainty provisions of the CFMA and the related provisions of the Bankruptcy Code (adopted by Congress in 1990) may have enhanced the ability of market participants to deal effectively with events such as the collapse of Enron.

dence that the Commission's antimanipulation authority is deficient. Again, the CFMA contributed positively to the ability of the markets to respond effectively to a difficult situation.

#### **Possible Amendments to the CFMA Affecting OTC Derivatives**

As noted, there have been several proposals to amend the provisions of the CFMA governing OTC derivatives. The most far-reaching of these proposals involve OTC derivatives based on foreign currency. One such amendment was included in S. 1566, which was approved on July 29, 2005, by the Senate's Committee on Agriculture, Nutrition, and Forestry in legislation (S. 1566) to reauthorize the CFTC. ISDA has concerns with the proposed amendments affecting foreign currency transactions, including those contained in S. 1566, and welcomed the recent decision of the PWG to review the relevant policy issues. In addition, ISDA has concerns with respect to proposals that may be advanced as the legislative process moves forward to amend the CFMA provisions applicable to OTC derivatives based on energy and other "exempt commodities." ISDA's comments on these proposed amendments to the CFMA are set forth below.

*Foreign Exchange Contracts-Zelener Issues.* In the CFMA, Congress revised the so-called "Treasury Amendment" (the core provision of the CEA governing foreign exchange contracts) to provide legal certainty with respect to OTC foreign exchange contracts and, in so doing, gave the CFTC jurisdiction over certain specific transactions in foreign exchange contracts, but only if and to the extent those contracts are "futures" or "options". In *CFTC v. Zelener*,<sup>4</sup> the U.S. Court of Appeals for the Seventh Circuit held that the foreign exchange contracts before it were not "futures contracts" and that the CEA's antifraud rules were therefore not applicable. In ISDA's view, the *Zelener* case was correctly decided based on the evidence before the court, does not preclude the CFTC from successfully bringing similar cases in the future,<sup>5</sup> and does not provide a "road map" for an "end run" around the CEA that can be "exported" to physical commodities such as heating oil and grain.

At the same time, however, ISDA recognizes that any fraudulent or manipulative activity involving the capital markets does warrant attention. In the case of the foreign currency markets, the involvement of the Department of the Treasury and the Federal Reserve (working in this case through the PWG) is critical and Congress has so recognized since the original adoption of the Treasury Amendment in 1974. Thus, while ISDA does not believe that statutory changes are necessary or warranted as a result of the *Zelener* decision, it could support a carefully crafted amendment if the PWG concludes that a legislative change is appropriate given the totality of the circumstances. ISDA will therefore give any such PWG recommendation serious consideration.

ISDA does believe, however, that in principle any such amendment should be quite narrow in scope. Specifically, in ISDA's view, if the CFTC's jurisdiction is to be expanded to include agreements, contracts, and transactions that are not futures or options, that expanded jurisdiction should be expressly limited to authorizing the CFTC to pursue fraud claims in transactions in foreign exchange contracts between retail participants (that is, participants who are not eligible contract participants under the CFMA) and otherwise unregulated persons.

Such a narrow approach has two distinct and important benefits. First, it will reduce the risk of unintended collateral consequences that could undermine the legal certainty provided by the CFMA for OTC derivatives. The risk of such unintended collateral consequences is neither speculative nor academic. For example, S. 1566 would amend Section 9 of the CEA to clarify the CFTC's jurisdiction with respect to false reporting. In its explanation of that amendment, the proposed Report of the Committee on Agriculture, Nutrition, and Forestry on S. 1566 contains the following statement:

The Committee concurs with the CFTC's consistent position that even if a transaction is excluded from the CFTC jurisdiction under Section 2(g) [of the CEA as added by the CFMA], the false reporting of such a transaction is a separate act and remains a violation of Section 9 so the CFTC has authority to prosecute.

<sup>4</sup> 373 F.3d 861 (7th Cir. 2004).

<sup>5</sup> In remarks prepared for delivery on March 17, 2005 at the Futures Industry Association International Derivatives Conference, CFTC Commissioner (and then Acting Chair) Sharon Brown-Hruska stated that "while developments like *Zelener* represent a set-back to our enforcement authority, I do not believe they preclude us from prevailing in these cases, even in the Seventh Circuit. A more focused litigation strategy, one that relies upon the extrinsic evidence surrounding the formation of the contract should, in our view, allow us to prevail in the future . . . ."

The effect of this statement, which in ISDA's view does not follow from a reading of the statute itself, is that an allegedly false statement made by a person to a third party will trigger CFTC jurisdiction over that person even if the statement is made about a contract with respect to which the CFTC has no jurisdiction, including anti-fraud jurisdiction.

The position that the CFMA exclusions such as Section 2(g) protect only the "agreements, contracts or transactions" themselves and not the persons who participate in those transactions is inconsistent with the understanding of market participants concerning the scope of the legal certainty provisions of the CFMA and will likely erode the legal certainty protections intended by Congress in 2000. Moreover, such a construction is unnecessary to achieve the apparent legislative objectives, which ISDA supports, with respect to Section 9.<sup>6</sup>

The second benefit of a narrow approach to any *Zelener*-related amendment to the CEA is that it will limit the extent to which the CFTC is required to divert its limited resources from its core function of providing effective oversight of exchange traded futures and options contracts. Congress has on prior occasions evidenced a healthy skepticism toward proposals that would enlarge the CFTC's consumer protection mandate with respect to contracts not otherwise subject to its jurisdiction and it should continue to do so.

*Foreign Exchange Contracts-Affiliates and Solicitors.* Proposals have been made to limit the ability of firms to create a so-called "shell" futures commission merchant (an FCM) that would enable an entity related to the shell FCM (a material affiliated person) to qualify under the Treasury Amendment (as revised by the CFMA) to engage in OTC foreign exchange futures transactions with persons who are not eligible contract participants. Under these proposals, an FCM would have to be well-capitalized and engaged in the conduct of the regulated futures business. In addition, proposals have been made to require persons who market transactions covered the Treasury Amendment to register with the CFTC unless the person is either an entity otherwise eligible under the Treasury Amendment to engage in the transaction or an employee of such an entity.

If appropriately drafted, ISDA could support amendments to address the shell FCM and unregistered solicitor issues. ISDA could not, however, support amendments to the CEA that would prohibit those who are material associated persons with respect to broker-dealers from engaging, in accordance with the CFMA, in OTC foreign exchange futures transactions with persons who are not eligible contract participants. There has been no evidence of any inappropriate conduct in transactions involving these entities and they are generally well-capitalized.

*Energy and Other Exempt Commodities.* As the Committee is aware, in recent years, proposals have been offered in the Senate in connection with energy-related legislation to amend the provisions of the CFMA providing legal certainty for OTC derivatives based on energy and other so-called "exempt commodities." These proposals, which would expand regulation of the OTC markets involving exempt commodities, have been consistently opposed by the PWG on policy grounds and, in case of energy-based derivatives, on the additional basis that enforcement actions taken by regulatory agencies and the Department of Justice rendered them unnecessary. ISDA shares the views of the PWG and urges the Committee to oppose any amendments to the CFMA based on these prior proposals.

## Conclusion

OTC derivatives contribute substantially to the flexibility and resiliency of our financial system. They allow businesses, financial institutions, governmental entities, and other end users to manage the financial, commodity, credit, and other risks inherent in their core economic activities in an efficient manner. The CFMA provided legal certainty and regulatory clarity for OTC derivatives in a manner consistent with the long-standing policies of Congress and the CFTC that OTC derivatives are not appropriately regulated under the CEA as futures contracts. This policy, as codified in the CFMA, materially reduces systemic risk and encourages financial innovation.

On behalf of ISDA and its members, I thank you for this opportunity to present our views and am prepared to respond to any questions you may have.

<sup>6</sup>In this connection, ISDA notes that the energy legislation enacted earlier this year contains provisions intended to improve the quality of reporting by all parties to many energy transactions.

**PREPARE STATEMENT OF DANIEL J. ROTH**

PRESIDENT AND CHIEF EXECUTIVE OFFICER

NATIONAL FUTURES ASSOCIATION

SEPTEMBER 8, 2005

My name is Daniel Roth, and I am President and Chief Executive Officer of National Futures Association. Thank you Chairman Shelby and Members of the Committee for this opportunity to appear here today to present our views on some of the issues facing Congress as it considers legislation to reauthorize the Commodity Futures Trading Commission (CFTC). NFA recognizes the importance of completing the reauthorization process as quickly as possible. At the same time, however, we feel that Congress must deal with important issues involving the protection of unsophisticated retail customers.

NFA is the industry-wide self-regulatory organization for the U.S. futures industry. Regulation is all we do at NFA—we do not operate a marketplace and we are not a lobbying organization. As a regulator, NFA is first and foremost a customer protection organization. Our mission is to provide the futures industry with the most effective and the most efficient regulation possible.

Our approximately 4,000 members include futures commission merchants (FCM's), introducing brokers (IB's), commodity pool operators (CPO's), and commodity trading advisers (CTA's). We also regulate approximately 54,000 registered account executives who work for our members.

As a regulator, NFA's main responsibilities are many and varied. We establish rules and standards to ensure fair dealing with customers; we perform audits and examinations of our members to monitor their compliance with those rules; we conduct financial surveillance to enforce compliance with NFA financial requirements; we provide arbitration and mediation of futures-related disputes; we perform trade practice and market surveillance activities for a number of exchanges; and we conduct extensive educational programs both for the investing public and for our members. We also perform a number of regulatory functions on behalf of the CFTC, including the entire registration process—from screening applicants for fitness to taking actions to deny or revoke registrations when those fitness standards are not met. We perform these duties with a staff of approximately 235 people and a budget of over \$35 million, all of which is paid by the futures industry. Since NFA began operations in 1982, volume on U.S. futures markets has increased by over 1,200 percent—a great testament to the innovation and value of our futures markets. What most people do not realize is that during that same time period customer complaints in the futures industry are down by almost 75 percent. This drop in customer complaints was not an accident. It was the result of a close partnership between the CFTC, NFA, and the rest of the industry to make sure that we are allocating resources where they are most needed, that we do not duplicate each other's efforts and that precious regulatory resources are not squandered.

In the last reauthorization process, Congress made bold changes to the Commodity Exchange Act (CEA). The Commodity Futures Modernization Act (CFMA) rejected a highly prescriptive, outmoded approach to regulation in favor of a more flexible approach that focused regulatory protections where they were most needed. I am pleased to join the rest of the industry in noting the great success of the CFMA and the superb work of the CFTC in implementing exactly the kind of flexible regulatory approach that the CFMA envisioned. The CFTC and its staff have worked to reduce unnecessary and costly regulatory burdens for every segment of the industry while preserving the highest level of customer protection.

Though the CFMA has been a great success, it failed in one of its objectives that directly impacts customer protection. Before the CFMA, boiler rooms had found their unregulated niche in off-exchange forex, where widespread retail fraud was occurring. Congress attempted to resolve the so-called "Treasury Amendment" issue once and for all in the CFMA by clarifying that the CFTC does, in fact, have jurisdiction to protect retail customers investing in off-exchange foreign currency futures. The basic thrust of the CFMA in this area was that foreign currency futures with retail customers were covered by the Act unless the counterparty was an "otherwise regulated entity," such as a bank, a broker-dealer, or an FCM. Unfortunately, as we sit here today, there is as much uncertainty over the CFTC's authority to protect retail customers as there was 5 years ago. This uncertainty is clearly not what Congress intended in passing the CFMA.

The main problem stems from a decision in the Seventh Circuit Court of Appeals in a forex fraud case brought by the CFTC, the so-called *Zelener* case. In *Zelener*, the District Court found that retail customers had, in fact, been defrauded but that the CFTC had no jurisdiction because the contracts at issue were not futures. The

Seventh Circuit affirmed that decision. The “rolling spot” contracts in *Zelener* were marketed to retail customers for purposes of speculation; they were sold on margin; they were routinely rolled over and over and held for long periods of time; and they were regularly offset so that delivery rarely, if ever, occurred. In *Zelener*, though, the Seventh Circuit based its decision that these were not futures contracts predominantly on the terms of the written contract itself. Because the written contract in *Zelener* did not include a guaranteed right of offset, the Seventh Circuit ruled that the contracts at issue were not futures.

*Zelener* creates the distinct possibility that, through clever draftsmanship, completely unregulated firms and individuals can sell retail customers contracts that look like futures, act like futures and are sold like futures and can do so outside the CFTC’s and any other Federal regulatory body’s jurisdiction. To make matters worse, the rationale of the *Zelener* decision is not limited to foreign currency products. It is very likely that unsophisticated retail customers will be victimized by high-pressured sales pitches for futures look-alike products covering everything from foreign currencies to precious metals to heating oil. The CFMA recognized that these retail customers are the ones who most need regulatory protection, and that protection should not be stripped from them because a clever lawyer finds a loophole in the law.

I recognize that *Zelener* is just one case, and we should not overreact to it. It is true that the *Zelener* decision would allow the CFTC in other cases to present evidence that the FCM made oral representations about the customer’s right to offset. But the reality is that those cases will be almost impossible to bring. First, in most cases the sales pitch is not made by the FCM but by an unregistered, unregulated solicitor. It is not clear to me that any court would find that the nature of the contract between the customer and the FCM was transformed into a futures contract because of oral representations made by some third party, registered or not. Second, if the written contract is vague about a right of offset, I can guarantee that the salesman working the phone will be even more evasive. In my opinion, trying to work our way out of the *Zelener* problem through future enforcement actions puts an awful lot of chips on a bet that’s no sure thing.

We strongly believe that the *Zelener* decision makes it much harder for the CFTC to prove that contracts sold to retail customers to speculate in commodity prices are futures, makes it easier for the unscrupulous to avoid CFTC regulation and creates a real, live customer protection issue. Therefore, it is NFA’s view that Congress should address this issue.

The trick is to protect retail customers without upsetting jurisdictional boundaries that were agreed to in the CFMA. We agree with the CFTC and the industry that *Zelener* is not an easy problem to resolve. But it must be done if we are to protect retail customers from unscrupulous firms and individuals and the solution should not be limited to forex. Some have suggested that the best approach is to address *Zelener* only with respect to forex products on the grounds that forex is where the bulk of the fraud is occurring. I agree that forex is the current scam of choice among fraudsters and I know that those who favor a narrow fix have the best of intentions, but limiting a *Zelener* fix to forex ignores the history of sales practice fraud and will not, in our view, really address the problem.

In NFA’s 20-years of experience we have seen that boiler rooms really prefer to sell physical commodities that retail customers deal with all the time. Sugar, gold, unleaded gasoline, heating oil—these are the products that boiler rooms have historically favored. Foreign exchange rates, by contrast, are fairly arcane. Forex fraud mushroomed, however, after the 9th Circuit’s 1996 *Frankwell Bullion* decision made clear that the CFTC had no jurisdiction over forex futures contracts offered to retail customers. Congress attempted to deal with that problem in the CFMA, but the *Zelener* case basically negated that effort and made things worse by providing fraudsters with a road map on how to avoid CFTC jurisdiction not just for forex futures but for anything else. We are concerned that if Congress adopts a forex only fix to *Zelener* it will not close the unregulated niche—it will just move it to other commodities.

NFA and the exchanges have developed a fix to *Zelener* that goes beyond forex and does not have unintended consequences. Our approach codifies the approach the 9th Circuit took in *CFTC v. Co Petro*—which was the accepted and workable state of the law until *Zelener*—without changing the jurisdictional exemptions in Section 2(c). In particular, our approach would create a statutory presumption that leveraged or margined transactions offered to retail customers are futures contracts if the retail customer does not have a commercial use for the commodity or the ability to make or take delivery. This presumption is flexible and could be overcome by showing that the transactions were not primarily marketed to retail customers or

were not marketed to those customers as a way to speculate on price movements in the underlying commodity. I have attached a copy of our proposed language.

Our approach has a number of advantages:

- First, it codifies *Co Petro* and returns the law to its pre-*Zelener* state. This would give the CFTC jurisdiction over traditional futures contracts without expanding it.
- Second, it does not touch the interbank currency market.
- Third, Section 2(c) would continue to exempt the retail OTC forex activities of banks, broker-dealers, insurance companies, and similar entities from CFTC jurisdiction.
- Fourth, our approach does not change any of the CFMA exemptions for off-exchange transactions entered into by eligible contract participants.
- And last, but certainly not least, it protects retail customers by giving the CFTC the power to shut down unregulated boiler rooms and freeze their funds.

Our presumption is not meant to address already regulated instruments like securities and banking products. It would, however, ensure that scammers cannot tailor their written agreements to sell leveraged commodity products to retail customers for speculative purposes in a completely unregulated environment.

NFA believes that the solution to *Zelener* should go beyond forex. Others disagree. One thing we all agree on, though, is that if Congress does not adopt a broad fix to *Zelener* now and boiler rooms move to other commodities using *Zelener*-type contracts, Congress must be willing to reopen the Commodity Exchange Act before the next reauthorization.

Unfortunately, the *Zelener* decision is not the only problem we have encountered with retail forex. Since passage of the CFMA, a number of firms—that do not engage in any other regulated business—have nonetheless registered as FCM's to qualify to be an otherwise regulated entity and have become NFA Forex Dealer Members for the sole purpose of acting as counterparties to retail customers in these transactions. For example, just 2 years ago, NFA had 14 active Forex Dealer Members and those Members held approximately \$170 million in retail customer funds. Since then, the retail forex business has continued to grow by leaps and bounds. Today, NFA has 31 active Forex Dealer Members holding over \$700 million in customer funds. That growth has not been problem free.

Though less than 1 percent of our member firms, forex dealers have accounted for 50 percent of our emergency enforcement actions and over 10 percent of our arbitration docket. I know the CFTC has been very aggressive in enforcement cases involving forex, though most of those cases have involved unregistered firms.

Obviously, retail forex has consumed a good deal of resources at NFA, but we are committed to doing whatever it takes to get our job done. Late last year, we appointed a blue ribbon committee to review all of our forex rules. It recommended, and our Board adopted, additional rules to strengthen both our financial requirements and sales practice rules for forex. We will continue to enforce our rules vigorously and bring actions whenever necessary to ensure compliance with our rules. Part of the problem, though, is that some firms can operate beyond our reach, in a completely unregulated environment, because of an unintended glitch in the wording of the CFMA.

As I mentioned before, the basic thrust of the CFMA was that only “otherwise regulated entities” could offer retail customers off-exchange foreign currency futures. Unfortunately, the wording of the statute only requires the counterparty to be an otherwise regulated entity. This creates the possibility that an FCM, for example, might be the counterparty but the firm that actually does the telemarketing for these products is completely unregistered and unregulated. There are literally hundreds of these unregulated firms doing telemarketing of off-exchange forex transactions to retail customers and in some instances the people making the sales pitches have been barred from the futures industry for sales practice fraud. I do not think that is what Congress intended at all and NFA would support an amendment to Section 2(c) of the Act to make clear that not only the counterparties but also the persons actually selling these products to retail customers must be “otherwise regulated entities.”

There was one more forex problem I should mention, though we are hopeful that it is a problem we can solve through NFA rules without any further legislation from Congress. Section 2(c) of the CEA could be read to allow unregulated affiliates of FCM's to act as counterparties to retail customers if the FCM makes and keeps records of the affiliates under the CEA's risk-assessment provisions. Some firms have tried to take advantage of this provision of the Act by creating “shell” FCM's. These shell FCM's do not do any futures business and they do not do any retail

forex business. Their sole reason for existence seems to be to create affiliates that do retail forex business in a completely unregulated environment.

I do not think that that is what Congress had in mind. Therefore, NFA is currently working on a solution to adopt a larger minimum capital requirement for FCM's with retail forex affiliates. We hope these efforts will solve the shell FCM problem without the need for legislative relief.

In closing, let me state that NFA believes the industry and the public have benefited greatly from the enlightened regulatory approach that Congress adopted in the CFMA and from the CFTC's role in implementing the Act. We look forward to working with this Committee, other Congressional committees, the CFTC, and the industry to address the issues outlined above.

**RESPONSE TO WRITTEN QUESTION OF SENATOR SHELBY  
FROM RANDY K. QUARLES**

**Q.1.** In oral testimony before the Committee, the CFTC General Counsel identified a recent decision in the case of *CFTC v. Bradley* as supporting the Commission's interpretation of its enforcement jurisdiction under the Commodity Exchange Act. Have the members of the President's Working Group reviewed this decision? Do the members of the President's Working Group agree with the decision? Does the decision raise any issues or concerns that the Committee should consider or address?

**A.1.** The decision referred to by the CFTC's General Counsel during the September 8 hearing is an August 2005 order by the U.S. District Court for the Northern District of Oklahoma denying the defendants' motions to dismiss in the case of *CFTC v. Bradley*. In that case, the CFTC alleged that the defendants violated Section 9(a)(2) of the Commodity Exchange Act (CEA) by knowingly making, or causing to be made, false reports regarding the prices and volumes of transactions in natural gas to several reporting firms that compiled natural gas price indexes. In addition, the CFTC alleged that defendants did so in an effort to manipulate the price of natural gas futures and options contracts in violation of Sections 6(c) and (d) and 9(a)(2).

Natural gas is an "exempt commodity" under the CEA, and an "agreement, contract, or transaction" in an exempt commodity may be excluded or exempt from CFTC jurisdiction, respectively, by Sections 2(g) and 2(h) of the CEA. The defendants in *CFTC v. Bradley* requested dismissal of the CFTC's complaint by arguing that the CFTC has no jurisdiction over their activities based on the 2(g) and 2(h) exemptions. The *Bradley* court put the burden on the defendants to prove the exemptions applied. It found that the defendants offered no authority for the proposition that the 2(g) or 2(h) exemptions apply to reporting activities "related to" an exempt commodity or contract. The court's order denied dismissal of the case in part on a finding that the exemptions did not apply.

The President's Working Group on Financial Markets (PWG), of which Secretary Snow is chair, has not reviewed or formed an opinion about the August 2005 order in *CFTC v. Bradley*. Treasury consistently has taken the position that legal and regulatory certainty are essential for the smooth functioning of our financial markets. In the view of some observers the *Bradley* court's interpretation of the scope of the CEA exemptions has raised questions concerning the legal certainty of the exemptions and exclusions that were set out in the Commodity Futures Modernization Act of 2000 (CFMA). Other observers believe that the decision is in accordance with the CFMA's regulatory framework and accordingly does not raise questions about legal certainty. In light of the potential impact and complexity of these issues, and the differing opinions about their implications, I will recommend to Secretary Snow that the PWG take up the issues raised in the case of *CFTC v. Bradley*, but I do not believe that the PWG's consideration of these issues should delay legislative reauthorization of the CFTC.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO  
FROM PATRICK M. PARKINSON**

**Q.1.** In oral testimony before the Committee, the CFTC General Counsel identified a recent decision in the case of *CFTC v. Bradley* as supporting the Commission's interpretation of its enforcement jurisdiction under the Commodity Exchange Act. Have the members of the President's Working Group reviewed this decision? Do the members of the President's Working Group agree with the decision? Does the decision raise any issues or concerns that the Committee should consider or address?

**A.1.** The U.S. District Court for the Northern District of Oklahoma's August 2005 opinion in *CFTC v. Bradley* held that the fact that natural gas is an "exempt commodity" under Sections 2(g) and 2(h) of the Commodity Exchange Act (CEA) does not mean that any conduct or activity "related to" such a commodity is excluded from CFTC regulation under the CEA. In this case, the CFTC alleged that the defendants delivered false, misleading, or knowingly inaccurate reports on natural gas transactions to reporting firms in violation of Section 9(a)(2) of the CEA, and that the defendants did so in an attempt to manipulate the price of natural gas futures and options contracts on the NYMEX in violation of Sections 6(c), 6(d), and 9(a)(2) of the CEA.

While acknowledging that natural gas is an "exempt commodity" under the CEA, the court noted that Sections 2(g) and 2(h) of the CEA exempt an "agreement, contract, or transaction" in an exempt commodity, but "do not state that the CEA does not apply to any conduct or activity related to exempt commodities." Rather, the court found that "the exemptions are, by their terms, limited to contracts, agreements, or transactions." The court held that the defendants' false disclosures to the reporting firms did not fall within the ambit of Sections 2(g) and 2(h) and, accordingly, the exemptions were not applicable.

The PWG has not discussed the *CFTC v. Bradley* decision. Nonetheless, the Board has taken the position over the years that financial markets are best served by public policies that create an environment of legal and regulatory certainty. The *CFTC v. Bradley* decision employs reasoning that, particularly if applied more broadly, could undermine the legal and regulatory certainty that many had expected the CFMA to achieve.

**RESPONSE TO A WRITTEN QUESTION OF SENATOR BENNETT  
FROM CHARLES P. CAREY**

**Q.1.** The Commodity Futures Modernization Act (CFMA) of 2000 established regulatory parity between security futures and security options. This followed a President's Working Group report in 1999 recommending that both the SEC and CFTC work together to determine the regulatory framework for security futures. Do you support the regulatory parity that currently exists between security futures and security options? Do you think that the SEC should be involved in the regulation of security futures? If so, what is the SEC's role?

**A.1.** The CFMA provided roles to both the Commodity Futures Trading Commission and the Securities and Exchange Commission

as regulators of stock futures products, but did not go so far as to require security futures be regulated exactly as security options. This approach left room for recognition of the fact that security futures and security options are different products with different purposes and customers, while providing the SEC ability to ensure that security futures were not used to circumvent securities law prohibitions. The dual regulatory scheme of stock futures products has been challenging to date and the growth of single stock futures in the United States has been anemic, at best, while the products have flourished in other jurisdictions. The CBOT believes that these products should be given the best chance possible for success, and that whatever regulatory structure is in place, it should not hamstring the products with illogical treatment. The CBOT continues to believe that requiring absolutely identical treatment for two such different products and markets could function to hamper the growth of the new product unnecessarily.

One example of the difficult and unnecessarily burdensome regulatory system is the inability, at least to this point, of the SEC and the CFTC to afford rational regulatory treatment of margining for these products. Historically, the power to set margins for futures products has rested with exchanges. Congress recognized that futures margins were performance bonds, posted by both buyers and sellers of commodities for future delivery, to ensure the performance of obligations under the contract, especially if the price moved adversely to one's position. Because futures contracts are not assets, such as stocks, and because margins are not a credit function in the acquisition of an asset, exchanges typically set margin at levels designed to cover the risk of several days' price movement on a historical basis. The levels of margin, set as a dollar amount per contract rather than as a percentage of the price of the underlying product, can quickly be changed in the event of higher volatility in prices, in other words, increased risk. With the advent of more powerful data processing and sophisticated financial valuation models and techniques, this risk-based margining today can be applied more precisely to futures positions, measuring the risk inherent in individual positions as affected by other positions within the same portfolio. Using risk-based margining has provided participants in the financial markets with greater flexibility and efficiencies, while at the same time affording greater stability to the markets themselves.

As I said in my testimony, the CBOT hopes Congress will facilitate the margining of stock futures as futures contracts, recognizing that the economic function of a futures contract is not to acquire ownership of the stock, but rather is to act as a hedging vehicle. The CBOT also hopes Congress will provide needed clarity on the definition of narrow-based security indexes to avoid unintended confusion about potential dual regulation of futures on indexes of fixed-income securities, corporate bonds, and other non-equity securities that is hampering development of those products.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR BENNETT  
FROM MARC LACKRITZ**

**Q.1.a.** The Commodity Futures Modernization Act (CFMA) of 2000 established regulatory parity between security futures and security

options. This followed a President's Working Group report in 1999 recommending that both the SEC and CFTC work together to determine the regulatory framework for security futures. Do you support the regulatory parity that currently exists between security futures and security options?

**A.1.a.** Yes. Competing financial products should operate on a regulatory level playing field and be given the opportunity to prove their merits in the marketplace.

**Q.1.b.** Do you think that the SEC should be involved in the regulation of security futures?

**A.1.b.** Given the SEC's mandate and in light of the fact that the CFMA defined "security futures" as both "securities" and "futures," it would be very surprising if the SEC were not involved in the regulation of the product.

**Q.1.c.** If so, what is the SEC's role?

**A.1.c.** Given the statutory definition of "security futures," it appears perfectly appropriate for both the CFTC and the SEC to be involved in regulating these products, and we urge Congress to continue to encourage the two agencies to work together to develop a suitable regulatory framework for security futures. However, as indicated in my September 8 testimony, we do not believe that this effort should be conflated with the effort at developing a framework for portfolio margining. While a very desirable and achievable goal, such a framework should be developed for all financial products.

#### **RESPONSE TO A WRITTEN QUESTION OF SENATOR BENNETT FROM ROBERT G. PICKEL**

**Q.1.** The Commodity Futures Modernization Act (CFMA) of 2000 established regulatory parity between security futures and security options. This followed a President's Working Group report in 1999 recommending that both the SEC and CFTC work together to determine the regulatory framework for security futures. Do you support the regulatory parity that currently exists between security futures and security options? Do you think that the SEC should be involved in the regulation of security futures? If so, what is the SEC's role?

**A.1.** The International Swaps and Derivatives Association represents the world's leading dealers in swaps and other off-exchange derivatives transactions. Our members have benefited significantly from the legal certainty that the Commodity Futures Modernization Act of 2000 (CFMA) established for OTC derivatives. The CFMA also lifted a 20-year ban on security futures products. While, ISDA, as derivatives industry association, does not address the securities activities of its members, ISDA believes generally that regulations that create additional opportunities for market participants can be productive for the market itself. ISDA similarly subscribes to the principle that statutory schemes should not unduly favor specific products but should instead foster a level playing field that allows competitive forces to operate efficiently. Given the nature of these products and the SEC's role in the regulation and oversight of the underlying securities, the SEC would appear to have a legitimate regulatory interest in the development of secu-

urity futures. Congress should continue to encourage the SEC and CFTC to work together to carry out the intent of the CFMA.

**RESPONSE TO A WRITTEN QUESTION OF SENATOR BENNETT  
FROM DANIEL J. ROTH**

**Q.1.** The Commodity Futures Modernization Act (CFMA) of 2000 established regulatory parity between security futures and security options. This followed a President's Working Group report in 1999 recommending that both the SEC and CFTC work together to determine the regulatory framework for security futures. Do you support the regulatory parity that currently exists between security futures and security options? Do you think the SEC should be involved in the regulation of security futures? If so, what is the SEC's role?

**A.1.** NFA has no objection to regulatory parity between security futures and security options as long as the regulations work efficiently for both products. The current margin regulations—which were originally developed for security options—do not work efficiently for security futures. Portfolio margining has proven to be a more effective way to measure and reduce financial risk in the futures markets. Therefore, if regulatory parity is appropriate, the better approach is to allow futures-style portfolio margining for security options rather than to prohibit it for security futures.

Regulatory schemes that give regulators overlapping responsibilities tend to be less flexible and slower-moving than single-regulator schemes. Still, we recognize that both agencies have a stake in the security futures markets—the CFTC because of its expertise and its responsibility for futures on all types of underlying products and the SEC because of its interest in safeguarding the integrity of the securities markets. We have a good working relationship with SEC staff, and we are confident that we will continue that relationship regardless of the role Congress assigns to the SEC.